March 2015

Trust in water

Consultation on the PR14 reconciliation rulebook

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Overview

This document consults on our approach to the reconciliations required at the end of the 2015-20 price control to take account of past performance and different incentive mechanisms. We consider that setting out our approach now, will provide greater clarity to customers, companies and wider stakeholders, building trust and confidence in the water sector.

An important task in any periodic review is the calculation of adjustments to take account of past performance and incentive mechanisms. This is particularly important given that the way that adjustments are calculated can be complex and thus open to different possible interpretations.

In the 2014 price review (PR14) final determinations we acknowledged that PR14 represented a significant evolution of Ofwat's historical approach to price controls. As a consequence, it is not possible to rely on the approach and guidelines we used in the past for the reconciliation at the end of the control period. In our final determinations, we therefore committed to produce a 'PR14 reconciliation rulebook' at the end of March 2015.

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 the 2019 price review (PR19). We consider that this is a fundamental objective because it helps promote predictable and transparent regulation and therefore fosters trust 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 mechanisms that the rulebook will cover 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.

The PR14 reconciliation rulebook sets out our proposed approach to reconciling the incentive mechanisms set in PR14 and the outstanding issues from the PR09 reconciliation.

The way that reconciliation adjustments are calculated can be complex and open to different interpretations. We found this at PR14 in connection with the operation of the capital expenditure (capex) incentive scheme (CIS) mechanism. At a late stage in our determination process we considered there were a range of approaches to adjusting financial values to take account of inflation.

In the PR14 final determinations we stated that we could have taken a different approach to the treatment of indexation in the CIS calculations, which could have resulted in a lower RCV but owing to the timescale and possible last-minute disruption we elected not to do so. We explained that we would consult early in 2015-20 on whether our approach to adjusting for inflation was in the long-term interests of customers and whether a forward-looking adjustment (that is, from 2020) was appropriate.

This consultation fulfils our commitment from the final determinations. We consider that it is important because it provides early certainty for companies, their investors and customers.

The PR14 reconciliation rulebook also describes the way that we propose to reconcile companies' performance against the PR14 final determinations, 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).

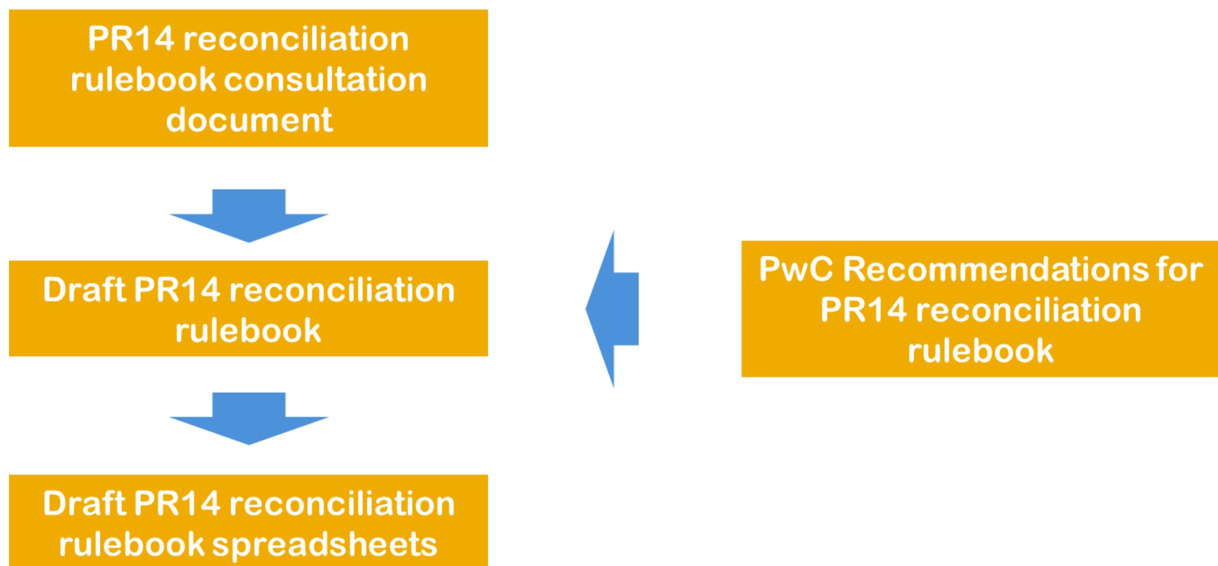
- **Household retail**, where the total revenue allowance is adjusted for actual customer numbers.

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 are seeking views on the suite of documents that set out our proposals for the PR14 reconciliation.

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

Figure 1 Structure of PR14 reconciliation documents



We have developed the PR14 reconciliation in line with our statutory duties. We would welcome responses on all parts of the recommendations that are set out in this consultation document, the PR14 reconciliation rulebook itself and the supporting spreadsheets. **We would appreciate responses around policy issues being focused around our statutory duties, for example why an alternative approach would be in customers' interests.** Appendix 7 sets out further details of responding to our consultation.

Table 1 Overview of the process for the reconciliation rulebook

Date	Phase
26 March 2015	Publication of PR14 reconciliation consultation
7 May 2015	**Deadline for responses to the consultation**
Mid-July 2015	Publication of decision on PR14 reconciliation

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

Table 2 below sets out our proposed 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, which is set out in appendix 1. We provide further details of our assessment of each of the policy areas in the appendices.

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 actual average year RPI to inflate PR14 values to PR19	
Time value of money	Do not adjust for time value of money	
Taxation	Allow taxation on ODI rewards and penalties as part of PR19 review	
Aggregate cap and collar	Do not adjust ODI rewards and penalties for taxation 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 RPI for comparison for PR14 allowance	
Allocation of totex out and under performance 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	Include a taxation adjustment for RCV changes only	
Wholesale – WRFIM		Appendix 3
In period ODIs	Exclude revenue changes from in-period ODIs from WRFIM reconciliation	
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
Indexation in the CIS RCV	Adjust PR19 opening RCV for amount remaining in the RCV due to the use of different indexation assumptions. This would result in a reduction in the overall industry RCV from 2020.	
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	
Time value of money	Do not adjust for time value of money	
Taxation	Do not adjust for taxation	

Appendix 1: Assessment framework

In the final determinations we defined the mechanisms that would apply over 2015-20. However, 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 thus the contents of the reconciliation rulebook, we have developed and applied an assessment framework.

In this section we set out the assessment framework and how we apply it to assess different options.

A1.1 Principles and criteria for assessment

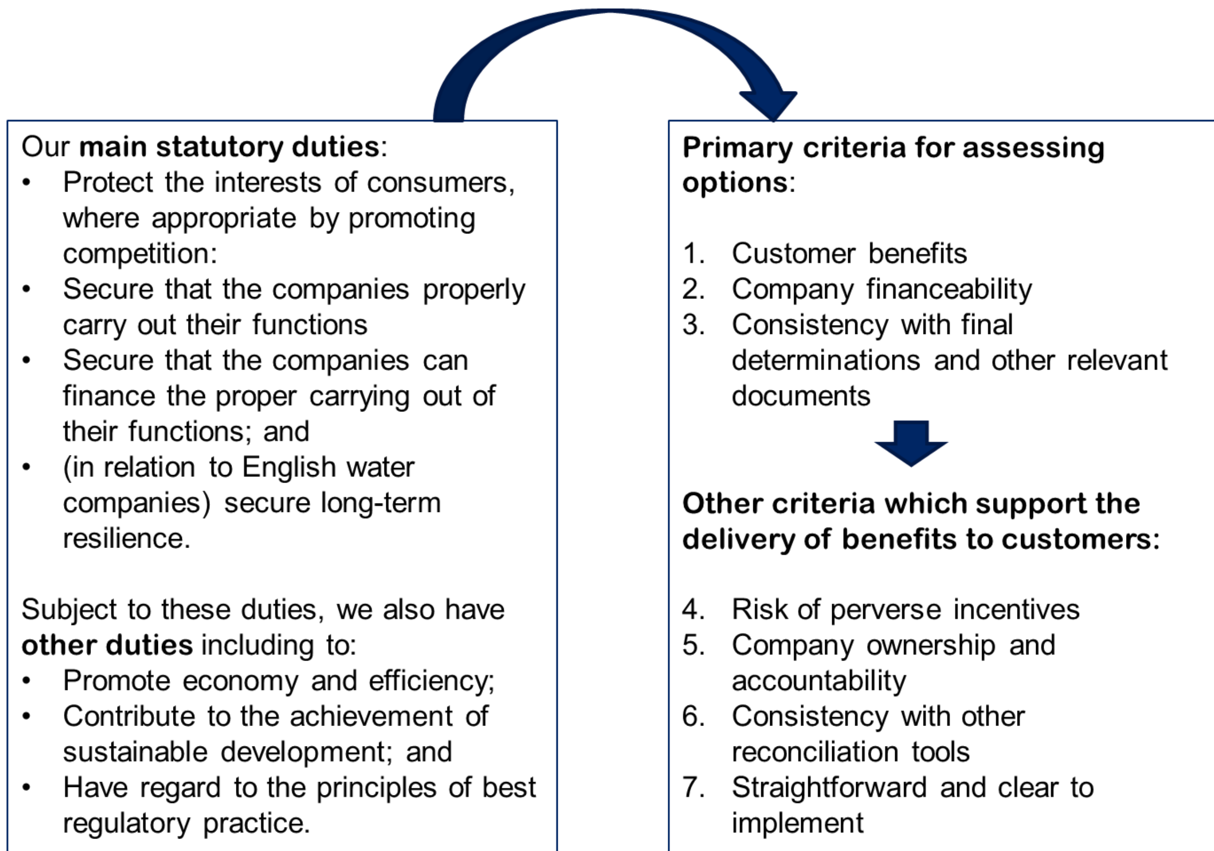
Our PR14 final determinations were made:

- in accordance with our statutory duties;
- with regard to the relevant guidance from the UK Government and the Welsh Government; and
- consistently with the principles of best regulatory practice under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only in cases where action is needed.[1]

It follows that the mechanisms used to reconcile companies' performance against the final determinations should also flow from these duties, guidance and principles. We have therefore translated these factors into criteria, as illustrated in the figure below.

[1] Page 6, Final price control determination notice: policy chapter A1 – introduction, Ofwat, December 2014

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 finely balanced, requiring trade-offs between criteria; often the assessment is finely balanced between options 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. We note that in PR14 we assessed financeability on a notional basis, pre-reconciliation adjustments. Therefore, our assessment assumes that financeability at PR19 will be assessed before taking account of the impact of PR14 reconciliation mechanisms.
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 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.

A1.2 Scope of assessment

The assessment of key policy decisions against the criteria are set out in the remainder of this document. 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

One of the key features of the PR14 final determinations was the introduction of outcomes. For the first time in the water sector, companies are being incentivised to deliver the outcomes that their customers need, want and can afford. Alongside the outcomes, companies have proposed set of measures that will demonstrate how well each of the outcomes is being delivered – these are referred to as performance commitments. Associated with each commitment is an outcome delivery incentive (ODI). In the case of financial ODIs these reward a company for stretching out-performance and penalise a company for under-performance.

The PR14 final determinations included 522 performance commitments and 316 financial outcome delivery incentives. 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.

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.

The detailed approach to the reconciliation of outcomes is provided in the PR14 reconciliation rulebook and the accompanying spreadsheets. This chapter sets out the proposed treatment of the following key issues in the reconciliation of outcomes.

- **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 receive an adjustment 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 determination.

- **The treatment of scheme ODIs** where the level of detail varies between companies and 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

In the final determinations, annex 4 of the company-specific appendices set out the financial rewards and penalties applicable for each ODI for each company. The final determinations did not specify a price base for these financial rewards and penalties. Consequently, in keeping with the rest of the final determinations, the figures 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.

For those ODIs that will be paid at the end of the 2015-20 period, we consider that the most appropriate approach is to 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 RPI between 2012-13 and 2017-18 (based on financial year averages).

Three companies (Anglian Water, Severn Trent Water and South West Water) have been granted licence changes to allow some ODIs to be paid during the 2015-20 period. It will not be possible to use the outturn retail price index to uplift rewards and penalties as the retail price index for the year in which the ODI will be paid will only be known at the end of the year. The setting of k, and wholesale revenue allowances, deal with this issue by using lagged November to November retail price index inflation to convert prices from one year to the next. We have considered three options for indexing in period ODIs.

Option	Description
Option 1	Use lagged November to November RPI, consistent with the setting of k in the wholesale controls.
Option 2	Use a nationally published forecast average RPI (without further adjustment), for example, RPI could be based on forecasts from the Office of Budget Responsibility.
Option 3	Use a nationally published forecast average RPI with a one off adjustment at the end of the period to correct for the difference between forecast and outturn average RPI.

We consider that Option 1: using lagged November to November RPI is the appropriate approach for the following reasons.

- It is consistent with the indexation used in setting k and the wholesale revenue forecasting incentive mechanism, allowing revenue changes from ODIs to be easily identified and separated from other revenue adjustments.

- It is consistent with other in-period adjustments; it is clear and straightforward to operate.

- If RPI is volatile, then the lagged nature of the adjustment could mean that changes in rewards and penalties get out of line with changes in prices in the rest of the economy. However, in period financial ODIs are small in relation to the overall revenues in the price control and any differences between outturn financial year average RPI and lagged November to November RPI are likely to be small. There may also be less consistency with the indexation of totex (which is used as the basis for some ODIs) although we do not consider that this is a significant issue.

- It avoids the use of external forecasts, which could be perceived as being inconsistent with other elements of the price control (and may themselves be inaccurate) and a wash-up which would increase complexity and delay the full adjustment until the end of PR19.

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

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.

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).

The wholesale revenue forecasting mechanism takes account of the time value of money by increasing the over- or under-recovery of revenue in a particular year, by the weighted average cost of capital, until the over- or under-recovery is taken into account in setting charges. The weighted average cost of capital is used as any over- or under-recovery of revenue can be used to pay down (increase) debt or equity, until the time that it is repaid. This effect is in addition to the adjustment for inflation. For example, suppose a company over-recovered £5 million of revenue in year 1, and only adjusted charges in year 3 to take account of this over-recovery. During this time it uses the money to pay down debt and equity (or reduce the amount that would have been required to fund the company's capital programme). Consequently the charges in year 3 should be adjusted by £5 million multiplied by 1.036^2 (where 3.6% is the cost of capital and there are two years between the over-recovery and repayment) = £5.36 million (all in constant prices).

We consider that there are two options.

- Option 1: Do not adjust ODIs for the time value of money.
- Option 2: Adjust ODIs for the time value of money.

We consider that we should NOT adjust for the time value for ODIs. A time value of money adjustment is generally used where there is a timing difference between when money is paid out (or received) and when it is reimbursed. This is not the case for ODIs. For most ODIs it was always envisaged that the changes in revenues would only take effect in the next price control. While it can be argued that to achieve some ODIs companies may have to incur additional expenditure, 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. We therefore do not consider that not adjusting for the time value of money, where we have done for other incentive mechanisms such as totex, creates a consistency issue.

In addition, all companies had the option to have a licence adjustment so that they could crystallise ODI performance earlier. Only three companies have requested such licence amendments, and consequently it is appropriate that these companies are able to receive their ODI rewards and penalties earlier, and receive the financial benefit from being able to do so. While it could be argued there is a risk that, in the absence of a time value of money adjustments, companies with in period ODIs may try to delay penalties, this is unlikely to occur in practice as Ofwat, as well as the companies, has the ability to initiate an in period adjustment.

Lastly, for some companies it is not clear whether adjustments are meant to be calculated in each year, or calculated at the end of the period based on annual performance. For example:

- 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].

The timing of the calculation is particularly an issue where 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]. To avoid distorting fast and slow money recovery we expect the adjustments to be based on net performance over the period rather than the rewards and penalties in each of the individual years.

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		

[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.

Criteria	Option 1: No time value of money adjustment	Option 2: Time value of money adjustment
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 and therefore tax allowances) whereas penalties would reduce the tax allowance (as they would reduce total revenues, forecast profits and therefore tax allowances).

The tax treatment of financial ODIs is complicated by four factors.

- **Final determinations** were silent on whether the overall adjustment to allowed revenues for ODIs is intended to include an adjustment for tax.

- **Treatment of the RCV in the financial model**, where all elements of the RCV impact on the tax allowance, and so if a taxation allowance was not applied to ODIs, these would need to be factored down before inclusion in the RCV (which is further complicated as the effective taxation rates for companies vary due, for example to their capital allowances).

- **In period ODIs**, which receive a revenue adjustment in-period, however there is no tax reconciliation mechanism for in period revenue adjustments within the PR14 methodology.

- **Customer wiliness to pay**, where the financial incentives for a large number of ODIs have been based, at least in part, on customer willingness to pay, typically without an explicit separate tax allowance. This suggests that customers have indicated their total willingness to pay for a specific outcome, which does not include a separate tax adjustment.

To illustrate how tax affects ODIs consider a company which accrues a net reward of £1 million by PR19 based on its ODI rate in its final determination. The company wants to take that reward via revenue at PR19. If we assume the company has a marginal tax rate of 20% then if the reward is paid pre-tax the company earns a revenue adjustment of £1 million. But if the reward is paid post-tax the company earns a revenue adjustment of £1.2 million to take account of the 20% marginal tax rate.

We consider that there are four options for the tax treatment of ODIs.

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

Note: The PR19 tax adjustments will be based on the taxation position of the companies at the time.

We consider that, on balance, **Option 2: providing a tax allowance for all ODIs is the most appropriate approach**, although we acknowledge that each approach has drawbacks.

This approach would be consistent with a post-tax regulatory regime (where the price control revenue allowances are calculated on a post-tax basis).

This approach would avoid the potential inconsistencies (and perverse incentives) of alternative approaches in that all ODIs would receive a tax allowance regardless of whether they were paid in period or at the end of the period, or whether they result in revenue or RCV adjustments. If there are differences in tax treatment between revenues and RCV adjustments (for example under Option 3) then this could encourage companies to focus on ODIs which have the most beneficial tax treatment, for example revenue rewards or RCV penalties.

Adjusting ODIs paid via the PR19 RCV to offset the tax effect (Option 4) would effectively mean that all ODIs could effectively be pre-tax (that is, there would not be an additional tax allowance). This adjustment could be made on the basis of marginal tax rates or the effective marginal tax rate in PR19. However, this process could add further complexity to the process and move ODI rates away from what customers were consulted on (although customer impacts might better reflect customer willingness to pay). However, if this tax adjustment could be made simply we consider that this approach might have benefits.

While providing a tax adjustment would reduce the link to customer willingness to pay, not all ODIs were based on willingness to pay, for example, some were based in all or in part on costs (where a tax adjustment is more appropriate). In addition, customer willingness to pay was identified at the time of company business plans rather than when incentives are due to be paid (and willingness to pay is considered to increase with income rather than inflation) and so the link with willingness to pay is not precise. We recognise that this loosening of the link between willingness to pay and ODI rates is not ideal. However, the effect is to increase both penalty and reward rates. As companies in aggregate have higher exposure to penalties than rewards the net effect for customers might be expected to be positive.

In period ODIs can receive a taxation adjustment based on the marginal tax rate of 20%. Each of the three companies that receive in period ODIs (Anglian Water, Severn Trent Water and South West Water) has received a tax allowance as part of its final determination. Consequently, any increase (or reduction) in revenues would be expected to impact at the marginal tax rate.

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				

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)
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 – 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.

The application of 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.

As a consequence of providing a tax allowance in addition to the rewards and penalties for ODIs, we need to consider whether the aggregate cap and collar of 2% of equity should be adjusted to reflect the additional allowance for tax. We have therefore considered two options.

In Option 1 we have specified the cap and rewards and penalties adjusting for tax. As both the rewards, penalties and cap are on the same basis we have not applied the 80% factor to the rewards and penalties (which was done to reflect a notional marginal tax rate of 20%)

In Option 2 we have taken the position from the final determination where we specified the cap and collar to operate on a post-tax basis. 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. These options and our assessment are illustrated in Table A2.4 below.

We consider that **Option 1, which 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. Although we acknowledge that it would depart from some of the detail of the final determinations (although the policy intent is the same). The impact of both Option 1 and 2 would have a mixed impact on customers in that under Option 1 not factoring penalties before comparison with the cap would effective increase the scope for penalties (providing greater customer compensation and benefits) but it would also increase the scope for company rewards (which could increase customer bills going forwards).

We note that if our approach to the treatment of taxation for ODIs changes then we are likely to revert to Option 2 to ensure consistency of tax treatment across different elements of ODIs.

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 PR14 final determinations included a number of scheme ODIs. The key aims of these ODIs were to ensure that:

- companies are incentivised to deliver the outcomes for customers associated with the delivery of major schemes; and
- customers are protected where a company fails to deliver on its commitments.

The form of major scheme ODIs differs between companies, as do the arrangements for measuring progress towards the delivery of the schemes. There are four main categories of ODIs related to major schemes, based on the information available in the final determination and in companies' business plans.

- **Delivery of scheme** – ODIs where companies are incentivised to deliver the scheme in its entirety.

- **Delivery of statutory requirements** – ODIs which are linked to meeting statutory requirements.

- **Delivery of milestones** – ODIs where companies have identified detailed milestones and linked incentives to the delivery of these milestones.
- **Delivery of measureable outcomes** – ODIs where the companies have identified measureable outcomes linked to the delivery of the scheme.

Given this range of scheme ODIs, we have considered 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 range from Do nothing (Option 1) through setting principles that will apply to the assessment of major scheme ODIs in PR19 (option 2) to a full review of schemes by Ofwat (Option 5). The options are incremental.

Intervention	1	2	3	4	5
Intervention now					
None	✓				
Ofwat sets principles that will apply to the assessment of major schemes		✓	✓	✓	✓
Ofwat encourages companies to clarify definitions of delivery for all major scheme ODIs highlighting the benefits of transparency for all players. Companies would mainly interact with CCGs in this process. Ofwat may undertake a limited review of consistency with the final determinations.			✓	✓	
Ofwat undertakes a full review of major scheme ODIs and mandates companies to publish specific information (for example, milestones or outputs on how delivery is assessed for all the schemes where issues have emerged).					✓
In-period					
Company reports performance as outlined in the company-specific Appendix (for example, to their CCGs) and via annual regulatory reporting	✓	✓	✓	✓	✓
Ofwat undertakes an interim review in 2017-18 to review the delivery of a number of major schemes				✓	✓
At PR19					
Ofwat reviews delivery of schemes at PR19 against evidence provided	✓	✓	✓	✓	✓
Ofwat applies lessons learned from the interim review to other major scheme ODIs at PR19				✓	✓

We consider that **Option 2: Ofwat setting principles that will apply to the assessment of major scheme ODIs** is the most appropriate response as:

- it will provide customer benefits by providing greater clarity on how we will assess scheme ODIs in PR19;
- it is consistent with the final determinations in that it is not requiring companies to set out additional details of how ODIs are going to be achieved;
- it reduces the risk of perverse incentives, for example, if companies continue to deliver a scheme that is not in customers' interests although there is still some risk of different views on delivery and therefore uncertainty in PR19;
- it maintains company ownership for the delivery of schemes and the burden of proof that the scheme ODIs have been delivered; and
- it should be straightforward and clear to implement, although there is some risk of a resource burden at PR19 if significant information is required to be assessed.

Our proposed principles for the assessment of major schemes are as follows.

- In case of inconsistencies, the final determination document takes precedence over any additional documentation.

- 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; and/or
  - it has started to deliver the originally intended benefits to its customers; and/or
  - an independent external party has confirmed the scheme has been delivered and is delivering the originally intended benefits[5]; 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

[5] 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.

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[6]. When making this assessment Ofwat will take into account evidence on customer preferences and benefits and the level of independent assurance provided.

- For the incentives regarding delay, we will undertake 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 undertake 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[7].

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					

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

Criteria	Option 1	Option 2	Option 3	Option 4	Option 5
reconciliation tools					
Straightforward and clear to implement					
Preferred option	×	✓	×	×	×

A2.7 Asset health ODIs

Twelve companies have asset health ODIs based on composite indices or 'basket' measures. For a number of companies[8] 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.

We have therefore considered two options to address this issue.

- Option 1: Do nothing – consistent with company ownership of plans it will be up to companies to demonstrate their performance is in line with the headline measure.

- Option 2: Require that companies publish further information on the operation of these indices and supporting formulae.

We consider that **Option 2: Companies publish further information on the operation of these indices and supporting formulae is the most appropriate approach** as this will reduce the risk of perverse incentives, for example, redefining the calculation of the asset health ODIs in period, with potentially negative impacts on customers. We acknowledge that this could introduce a risk of inconsistency with

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

the final determinations, although we are clear that the final determinations will take precedence over any additional information that is provided where there is a conflict.

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

We have consulted and concluded on the main elements of the SIM for the next period, in particular:

- the SIM will continue to be used from April 2015 onwards in a form similar to the PR09 incentive;
- we retain the current asymmetric structure of the SIM incentive;
- we will retain the financial magnitude of the current SIM (that is, the range of -1.0% to +0.5% on total integrated revenues), but will express this in terms of household retail revenues (+6% reward to -12% penalty);
- we will retain the current relative performance approach of penalising/rewarding companies according to their relative performance against others in the sector;

- we will shift the balance of measures for 2015 onwards more towards qualitative measures (75% qualitative/25% quantitative, from 50% qualitative/50% quantitative); and
- we will separately measure the service delivery to household and non-households.

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

A2.8.2 Other ODIs

We have reviewed the information provided in the final determinations. We consider that for the large part there is good information in the final determinations on how these ODIs will be measured and rewards and penalties will be assessed. However we accept that CCGs and other stakeholders may want additional information on how some ODIs are assessed, to ensure that they can hold companies properly to account. We can also imagine companies themselves will want to know information on how other companies are measuring their performance so that they can accurately compare their performance.

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

Appendix 3 Wholesale water and wastewater costs and revenues

A3.1 Introduction

The cost of delivering wholesale water and wastewater services is a major driver of customer bills, comprising about 90% of the value chain. We expect these costs to total about £40 billion of the price control for the 2015-20.

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 under performance is shared between the company and its customers based on the company's menu sharing rate.

- Wholesale revenue forecasting incentive mechanism, 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.

Due to their nature, both of these mechanisms are likely to raise different issues in the PR14 reconciliation.

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. This chapter therefore goes on to describe our proposed approach to these key issues in the reconciliation of totex cost sharing.

- **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 determination. For example pension deficit recovery costs will be included in companies' reported totex, but were not in the final determination allowances subject to cost sharing. We will therefore

need to adjust companies' reported totex before the cost sharing calculations can be undertaken.

- **Treatment of inflation.** The cost allowances in the final determinations (updated for menu choices) are set out in 2012-13 prices. The reconciliation therefore 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/under performance to RCV and revenue.** Totex can be 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 RCV). At PR19 the cost sharing with customers (for example, the proportion of costs the company can recover from customers) will need to be split 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 under performance 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 under performance was achieved and when the sharing with customers is undertaken 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 in PR19 so that the companies receive the net impact of cost out or under performance. The following sections deal with each of these issues in turn.

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

At PR19 we will need to work out each company's position on the published menu, which in turn will determine its cost sharing rate. To work out a company's position on the menu we need to compare reported totex with final determination totex and calculate its out- or underperformance. For this comparison we only need to consider the totex that is subject to cost sharing mechanisms, so we need to compare our baseline totex with company's menu totex.

In our final determinations we split our final totex allowances into those costs that should be subject to cost sharing incentives (which we termed the menu baseline or baseline totex) and those costs where cost sharing incentives would not be

appropriate. We also excluded some types of costs from our final totex allowances entirely, and included some expenditure in baseline totex that had been incurred outside of AMP6. We also set out a change in accounting treatment for shared assets for AMP6 which could impact on reported totex going forward. When we are using a company's out or under performance to calculate its cost sharing rate, we need to take account of all of these issues to adjust reported actual totex to make it menu totex.

The adjustments we consider necessary are summarised below and set out in more detail in the rulebook and associated spreadsheets.

- Third party costs were not included in our final determination menu baseline because they should not be subject to cost sharing incentives. Therefore they also need to be excluded from reported totex.

- Pension deficit recovery costs were excluded from our final determination menu because they should not be subject to cost sharing incentives, so they also need to be excluded from reported totex.

- Disallowables were costs that were not included in our final determination allowances at all because they did not fall under totex, were subject to other incentives mechanisms or did not lead to a customer benefit. These types of cost need to be excluded from reported totex.

- We included transition costs incurred in 2014-15 in our final determination menu baseline. These costs will not be included in AMP6 reported totex so we will need to include them.

- Our menu baseline was set using historic cost principles for shared assets. Going forward companies will use principle use accounting to allocate assets and will report recharges across different parts of the business as opex. We will need to adjust reported totex for these opex recharges as they were not included in our menu baseline.

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.

Our final determinations 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."**[9] We still consider that this is the appropriate approach and is consistent with the approach set out for end of period ODIs set out in this document.

A3.2.3 Allocation of totex out/under performance 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.

At the final determinations companies were able to propose their profile of PAYG rates (with Ofwat intervening in some specific cases) and so how much totex was recovered in period and over time. In most cases PAYG rates varied across the price control period. We did not state in our final determinations whether these PAYG rates would be used to allocate the customer impact of cost sharing between revenue and RCV adjustments. The choice of PAYG rate for the customer sharing of out and under performance can potentially have a material impact on future customer bills with a higher PAYG rate leading to a larger impact on future bills as performance differences are recovered over a shorter period of time. We do not consider that the choice of PAYG for customer sharing should have a material impact on notional financeability as our approach in PR14 (and in previous price controls) was to assess financeability based on a notional capital structure and before any reconciliation adjustments.

We consider that there are four options for allocating the customer share of totex out/under-performance between revenue and RCV, as set out below.

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

Option	Description
Option 1	**Allocate all the customer share of performance to revenue** – as this would most closely reflect the benefit received by companies which would be in period.
Option 2	**Allocate all the customer share of performance to RCV** – as this would spread any impact over future control periods minimising the impact on future bills.
Option 3	**Use weighted average PAYG rates** to allocate spend as this would reflect the effective PAYG rate in the 2015-20 and would reflect the basis of customer and company engagement for the business plan. Companies would also be allowed to justify why a change in these PAYG rates would be in customers' interests.
Option 4	**Allow companies to choose the PAYG rate** for any customer sharing, based on evidence that this was in customers interests.

We consider that **Option 3: using weighted average PAYG rates, with company justification that a divergence is in customer interests, is the most appropriate approach** as:

- a direct revenue adjustment could have a significant impact on customer bills;
- a direct RCV adjustment would allow companies to delay payment of outperformance and could reduce the link between company performance and customer bills;
- it would reflect customer preferences and company business plans for PR14;
- it would be consistent with a totex approach where out and underperformance may be spread across opex and capex;
- it would avoid potential distortions in incentives by using an average PAYG rate across the period rather than different PAYG rates for individual years; and
- it would provide a realistic baseline for companies to justify why a different PAYG rate would be in customers interests, avoiding extreme positions unless they could be justified.

Table A3.2 Assessment of options for the choice of PAYG rate for customer adjusting for time value of money for ODIs

Criteria	Option 1: All allocated to revenue	Option 2: All allocated to RCV	Option 3: Use weighted average PAYG	Option 4: Allow companies to propose
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	×	×	✓	×

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

Totex out and under performance 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 under performance was achieved and when the sharing with customers is undertaken by the company.

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).

We consider that there are three options for reflecting the time value of money in totex sharing.

Option	Description
Option 1	Do not include a time value of money adjustment
Option 2	Adjust all totex out and under performance for the time value of money
Option 3	Only adjust the non-PAYG component of totex for the time value of money as this reflects the financing cost treatment of PAYG and non-PAYG expenditure within the price control framework.

We consider that Option 2: adjusting all totex out and under performance for the time value of money is the most appropriate approach. A time value of money adjustment is generally used where there is a timing difference between when money is paid out (or received) and when it is reimbursed. This is the case for cost sharing where out or underperformance is achieved in specific years and only shared at the end of the period. During this time any outperformance can be used to reduce debt or equity requirements (with under-performance would increase requirements).

Allowing a time value of money adjustment for cost sharing would be consistent with other PR14 reconciliation tools in particular the WRFIM which provides a time value of money adjustment between where then the revenue out or under performance was achieved and when the reconciliation occurs. It would also be consistent with a totex approach as the same adjustment would apply to PAYG and non-PAYG elements of the price control.

A time value of money adjustment would also reduce the potential for perverse incentives as the adjustment would ensure that companies were neutral when cost savings (or increases) occurred. In the absence of an adjustment, companies would be incentivised to make savings early in the control period (as they could use this to reduce debt/equity requirements). This could lead to back end loading in the delivery of capex projects, which could delay benefits to customers (which were not otherwise reflected in ODIs).

Table A3.3 Assessment of options for the choice of PAYG rate for customer adjusting for totex sharing

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 reconciliation has considered whether the revenue and RCV adjustments that result from cost sharing with customers should receive an adjustment to take account of taxation in PR19 so that the companies receive the net impact of cost out or under performance. A tax adjustment will tend to amplify the impact to customers, i.e. it will increase the customer impact of any totex over spending (as an additional allowance for tax will be required) and any totex under spending (as the reduction in revenue will reduce the amount required for tax).

We consider that there are three options for the tax treatment of totex sharing.

- Option 1: Include a tax adjustment for the customer share of totex out/under performance in PR19.

- Option 2: Do not include a tax adjustment for the customer share of totex out/under-performance in PR19.

- Option 3: Only include a tax adjustment for the customer share on the RCV element of totex out/under performance in PR19.

We consider that each of these options has drawbacks. However, on balance we consider that **Option 3: only including a tax adjustment for the customer share of the RCV element of totex out/under performance in PR19 is the most appropriate approach** as:

- it would be simple to implement as it avoids having to make an adjustment to the customer share that impacts on the RCV (as the financial modelling assumes all RCV adjustments have a tax impact) which would increase complexity;
- it would maintain incentives for companies to outperform, otherwise incentives could be reduced as companies that outperform during the period would be paying more tax (as profits would be higher) which would not be recompensed; and
- it would avoid providing a double allowance for tax on the revenue elements of the customer share of totex. For example in PR14 a tax allowance was provided on top of the cost allowance to allow companies to fund the appropriate tax payment. If a company overspends on operating expenditure in period then it will pay less tax. At the next periodic review the company will claim the customer share of the overspend, which if unadjusted would receive an additional tax allowance. An overspend on capital expenditure in period would create greater capital allowances, and so would not necessarily reduce the tax bill in the period.

We note that this option could distort incentives between RCV and revenue adjustments and is mainly preferred over Option 2 (no tax adjustment) due to the potential complexity of netting out the tax for the RCV adjustment. If a simple method can be found to net out the tax from the RCV adjustment then we may take a different view.

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	×	×	✓

A3.3 WRFIM

Our approach to the WRFIM is set out on pages 51-55 of the final price control determination notice: policy chapter A7 – risk and reward. In this document we included significant detail on the operation of the **wholesale revenue forecasting incentive mechanism**, including:

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

However we as part of the PR14 reconciliation rule book we have identified a number of further issues that need to be considered. These issues are as follows.

- **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.

A3.3.1 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." We therefore consider that it is appropriate to consult on the proposed changes to deal with in period ODIs in the WRFIM mechanism.

We consider that there are two options on whether allowed revenues are adjusted for in period ODI rewards and penalties.

- Option 1: Include in period ODI rewards and penalties in the allowed revenues in the WRFIM calculations.

- Option 2: Do not adjust allowed revenues in WRFIM for in period ODIs.

We consider that **Option 1: including in period ODI rewards and penalties in the allowed revenues in the WRFIM calculations is the most appropriate approach** as:

- including in period ODI rewards and penalties from revenues should be relatively straight forward as both the allowed revenues and in period ODIs use the same price base for indexation;
- it would ensure consistency across all companies as only three companies have in period ODIs;
- it would maintain incentives for companies to manage revenues in period and reduce the risk that companies outturn revenues could be higher (or lower)

than otherwise making a WRFIM penalty more likely (which could trigger company submissions on why the penalty would not be appropriate); and

- it would maintain the incentives for companies to take in period rewards and penalties, enhancing the link between company performance and customer charges.

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.

We consider that there are two options for the treatment of taxation on the revenue adjustments that result from WRFIM.

- Option 1: Include a tax adjustment on the revenue changes that result from WRFIM in PR19.

- Option 2: Do not include a tax adjustment on the revenue changes that result from WRFIM in PR19.

We consider that **Option 2: do not include a tax adjustment on the revenue changes that result from WRFIM in PR19 is the most appropriate approach**. This is because it would ensure that companies would not receive a double allowance for taxation.

The key point to note is that revenue allowances for the 2015-20 period already includes an allowance for tax in allowed 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 companies allowed revenues would be adjusted up to reflect that it under recovered revenues in period. If this adjustment to revenues was allowed to impact on tax allowances in the next price control then the company would receive an additional allowance of tax, even though the company had paid less tax than allowed at the previous price control. Consequently the company would effectively receive an allowance for tax twice on the same revenue. We therefore consider that a tax adjustment for revenues in WRFIM would not be appropriate.

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 determination stated that the over or under recovery of allowed revenue will be applied through a true up mechanism at PR19[10]. The revenue adjustment for WRFIM is derived with a two year lag. The true up will therefore 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. The final determinations set out two scenarios to apply the WRFIM revenue adjustment to companies allowed revenue for actual performance in 2019-20[11].

- If the licence in place at PR19 does not allow changes to pre-determined allowed revenues during the 2020-25 period, then a true-up of allowed revenue would take place in the following periodic review (with relevant inflation adjustments).

- However if a company's licence allowed it at the time, the alternative would instead be to reflect the results of the true up of 2019-20 revenues in bills earlier, in the year 2021-22. We illustrated the operation of such a true up in the regulatory period from 2020-25 in section A6.1.3 of our April 2014 consultation on the WRFIM.

As part of the PR14 reconciliation we have considered whether, 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. For consistency with other reconciliation mechanisms we propose that **we make an adjustment in PR19 for the blind year based on forecast outturns** as this would:

- Reduce the scale of adjustment required in PR24; and
- Maintain a more direct link between company performance and bills.

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[10] Page 54 Final price control determination notice: policy chapter A7 – risk and reward
[11] Page 55 Final price control determination notice: policy chapter A7 – risk and reward

A3.4 Water trading incentives

Over the long term, we expect our totex approach to wholesale costs to encourage better, and more efficient, decisions on the use of water resources – including decisions on whether to develop new resources or purchase water from another water company or a third party. The Water Act 2014 and the UK Government's proposed long-term reforms to the abstraction licensing regime will also have a key role to play. However, we also want to improve the way companies use resources in the short term. For PR14 we introduced water trading incentives to encourage companies to trade water where it is beneficial to do so.

Following consultation we confirmed the main features of the water trading incentives in our methodology statement.

- For 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).

- Importers will benefit from totex efficiency sharing incentives and an extra 5% of the costs of water imported under new agreements – subject to the annual total of these extra payments not exceeding a cap of 0.1% of the importer's water activity turnover in any year of the control period.

Our water trading incentives will apply only to relevant price regulated companies and not to new appointees.

To qualify for water trading incentives, a company must comply with an Ofwat-approved Trading and Procurement Code. The code contains a company's obligations in respect of issues including definitions of trades, non-discriminatory procurement and rational trading.

Appendix 3 of the methodology statement[12] sets out the conditions that companies must include in their Trading and Procurement Codes, our advice on additional principles and the approval process for trading and procurement codes.

[12] http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproachapp3.pdf

Appendix 3 to the methodology statement states that, “Adjustments to price control revenue to take appropriate account of water trading incentives will be made at the 2019 price control review.” (Page 7.)

Our intention is that we award the water trading incentives retrospectively at PR19 provided a company has shown that its import or export complies with an Ofwat-approved Trading and Procurement Code. Our expectation is that the payments will be made through adjustments to price control revenue.

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)[13]. The lifetime of the export could last beyond the end of 2015-20. There are different ways in which we could interpret the methodology statement.

Option	Description
Option 1	Export incentive payment at PR19 equal to 50% of the economic profits for each year of 2015-20 that the export is in operation.
Option 2a	Export incentive payment at PR19 equal to 50% of the full discounted economic profit for the forecast life of the export.
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.
Option 3	Export incentive payment delayed until the export has completed when we will know the lifetime economic profit of the export and what 50% of that amounts to.

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

Our preferred option for the export incentive is Option 2b. Our intention behind the export incentive was to encourage efficient exports for the benefit of customers and the environment. We do not consider that the incentive will encourage exports if the payment is delayed until the end of the lifetime of the export. Conversely, allowing companies to recover the full discounted lifetime economic profit from an export at PR19 would make customers pay in 2020-25 for benefits which might arise many years after that period.

Whilst allowing a company to recover 50% of the economic profit for 2015-20 might be considered the most straightforward application of the export incentive it could involve a relatively small incentive payment at PR19 and would represent a lower export incentive than was available at PR14. This might not achieve the benefits for customers and the environment that can arise from efficient water exports. We consider paying companies an 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 strikes the right balance between incentivising exports and the phasing of customers' payments. This approach is consistent with final determinations as we did not discuss how the export incentive would be paid in our final determinations.

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				

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
reconciliation tools				
Straightforward and clear to implement				
Preferred option	×	×	✓	×

A3.4.2 The import incentive

There are two elements to the import incentive. First, 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 the 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.

Secondly the 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[14]. We therefore consider that the import incentive payments are accrued annually during 2015-20 with the cap applying in each year.

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

We have considered the most appropriate approach for indexation, time value of money and taxation.

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

The export incentive is based on 50% of lifetime economic profits. Unless 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 consider that the discounting should involve adjusting for both inflation and the time value of money. This is consistent with the adjustments made for totex. We consider it is 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.

We consider that we should follow the same approach to taxation as for ODIs as no tax allowance has been provided at the PR14 price control. This would result in a tax adjustment in PR19 and would be consistent with a post-tax regulatory regime (where the price control revenue allowances are calculated on a post-tax basis).

Table A3.8 sets out our preferred approach to adjustments for inflation, time value of money and taxation for the export and import incentives

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

A4.1 Introduction

The PR14 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 different RPI series had been used for the RCV and financing cost adjustment and we stated we would consult early in 2015-20 on whether a forward looking adjustment was appropriate;

- **The blind year adjustment for the PR09 incentives**, where full data 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 provisional 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.

The following sections consider each of these issues in turn.

A4.2 Indexation in the CIS RCV adjustment

In the PR14 final determination we explained that we received a representation from Severn Trent Water that concerned the operation of the indexation in the CIS RCV adjustment[15]. In particular Severn Trent Water identified that two different approaches to indexation were being applied to the two components of the CIS reconciliation (the RCV adjustment and the financing cost adjustment):

> "The established CIS methodology … adopts two different approaches to indexation for the RCV adjustment and the financing cost adjustment. For the RCV adjustment, the CIS compares allowed capex indexed using the construction output price index (COPI) forecast at the time of PR09 final determinations (what we term FD COPI) with actual capex, and deflates this difference using outturn RPI. For the financing cost adjustment, the CIS compares allowed capex indexed using FD COPI and then deflated to 2007-08 prices using RPI forecast at the time of PR09 with actual capex deflated to 2007-08 prices using outturn RPI."

In its representations Severn Trent Water argued, "that to calculate the financing cost adjustment, allowed capex should be deflated using the same index as used to deflate actual capex: outturn RPI." We stated in the final determinations that

> "We agree that changes could be made to the CIS methodology, in the ways suggested by Severn Trent Water, would be favourable to the company. However, we consider that if change were required there is an alternative approach which would be to base the RCV adjustment for allowed capex on the difference between COPI and RPI forecast at the time of the PR09 final determinations. This would bring the approach to indexation in the RCV adjustment in line with financing cost adjustment. This alternative approach would have resulted in lower opening RCVs across all companies in April 2015."

At the final determinations we decided not to make a change for the 2015-20 period to the way that we adjusted for inflation within the CIS mechanism. We agreed with

[15] Pages 41 to 43 Final price control determination notice: policy chapter A4 – reconciling 2010-15 performance

representations that alternative approaches were possible. However we considered that a late change risked creating regulatory uncertainty, which would not be in the long term interests of customers and might undermine trust and confidence in the regulatory regime. We therefore decided to retain the approach to indexation that we had proposed in the draft determinations for the 2015-20 period. This was because we had "made our final determination in the round, taking account of the RCV adjustment that companies have received through the 2010-15 CIS true-up, and allowing investors a reasonable return (with scope for out- and underperformance) on that basis."

For the period beyond 2015-20 we stated that

> "we would like to engage with stakeholders and consider whether this approach to adjusting for inflation, which may have resulted in a slightly different 2015 opening RCV (as a result of indexation) for all companies, is in the long term interests of customers. It will be appropriate for us to consult shortly on how we approach any adjustment to the RCV at PR19 as a result of indexation. If we consider an adjustment would be appropriate, there would be no need to adjust retrospectively for the revenues received in the interim. These have been correctly set in this price control review, based upon Ofwat's existing approach to inflation. Any change would have a prospective effect only, and would be applied industry-wide."

We are therefore fulfilling the commitment we made in the 2014 final determinations by considering whether an adjustment at PR19 is required to account for a different treatment of indexation in the CIS. Any adjustment would apply from 2020 onwards (that is, we are not making any retrospective changes).

Our preferred approach

The potential approaches for indexation of the CIS are set out below[16]. These forms of indexation are applied to the expenditure that was allowed at PR09 (that is, as opposed to actual expenditure that was incurred which is deflated using actual RPI):

[16] We also considered a further approach, as proposed by Severn Trent's consultants, KPMG at the time of the final determinations. This proposed that the RCV and financing adjustments should both be based on outturn COPI and outturn RPI. We do not consider that this is consistent with the PR09

Table A4.2 Potential indexation assumptions for the CIS – Allowed expenditure

Purpose		Alternative approach	FD Ofwat approach	Severn Trent approach
RCV adjustment	COPI assumption	PR09 FD	PR09 FD	PR09 FD
	RPI assumption	PR09 FD	Outturn	Outturn
Financing cost adjustment	COPI assumption	PR09 FD	PR09 FD	PR09 FD
	RPI assumption	PR09 FD	PR09 FD	Outturn

Note: PR09 FD – PRO09 final determinations forecast indexation

We consider that all three of these approaches could potentially be consistent with the original policy intent set out in the PR09 documentation. Therefore in considering which option is most appropriate we have taken into account our statutory duties and the recommendations made by PwC following their review of the 2010-15 adjustment models in November 2014[17].

The approach proposed by Severn Trent Water would lead to an increase in the revenue from the financing adjustment as outturn RPI was higher than that forecast at the time of the PR09 final determinations. Our approach to setting price controls leaves companies to manage inflationary risk given the indexation of both revenues and the RCV. We therefore do not consider that this approach would be in customers' interests as it would increase customer bills with no countervailing benefit for customers.

The alternative approach uses the final determination COPI and RPI assumptions for both the RCV and financing cost adjustment. This would remove the inconsistency between the indexation used for the different adjustments and would avoid a situation where the RCV was inflated purely as a result of the difference between two inflation indices. We consider that this approach is therefore preferable to the indexation approach used in the CIS mechanism at final determinations and is consistent with our statutory duties.

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policy intent and the CIS flow diagram set out in information note 12/08 and so did not consider this approach further.

[17] Reconciling 2010-15 Performance: Technical Review, PwC, November 2014

The CIS mechanism will no longer feature as an incentive mechanism in companies price controls in 2015-20. However we consider it is important to address this issue in the PR19 price control in long term customer interests. Consistent with the PR14 final determinations, we consider it would only be appropriate to make a forward looking adjustment. We have therefore considered whether we should adjust the RCV at the end of the PR14 period. We have not considered adjustments to the revenue that companies will have received during the 2015-20 period since this would imply a retrospective change.

On this basis we consider that there are two options for a forward looking CIS RCV adjustment.

- Option 1: Do nothing – that is, do not adjust the RCV at the end of PR14 to reflect the inconsistency between the indexation used for RCV and financing cost adjustment.

- Option 2: Do something, adjust the RCV in PR19 based on the amount remaining in the RCV from the use of outturn RPI rather than PR09 forecast RPI (that is, using the alternative approach set out in the PR14 final determinations).

Overall we consider that **Option 2: Adjust the RCV in PR19 to remove the amount remaining in the RCV from the use of different indexation assumptions** is the most appropriate approach as:

- establishing the correct baseline for the RCV going forwards is in customers' interests. The unadjusted RCV at PR19 would reflect the use of inconsistent indexation assumptions which would not reflect the true value of the RCV;
- it would not impact on company financeability in the current review period as these adjustments would only affect the RCV in the next control period and would be taken into account in PR19 in our pursuit of our statutory objectives; and
- it is consistent with the final determinations, in that it is a forward looking adjustment only.

Table A4.3 Assessment of options for the PR09 CIS RCV adjustment

Criteria	Option 1: Do nothing	Option 2: Do something
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	×	✓

The proposed adjustment to the RCV would affect all companies, and would be in proportion to their PR09 capital expenditure allowance. In total we consider that the potential midnight adjustment to the RCV is around 2% of the RCV, which would take place from 2020. This adjustment is likely to be outweighed by other adjustments to revenue and RCV from the PR14 reconciliation mechanisms, for example totex cost sharing.

4.3 Blind year reconciliation: use of materiality thresholds

The PR14 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[18].

[18] 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 PR14 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.”[19]

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

We consider that there are three options for making the blind year adjustment.

Option	Description
Option 1	Adjust each of the mechanisms in full in PR19, with no threshold for materiality.
Option 2	Apply a materiality threshold to each of the relevant PR09 incentive mechanisms using 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.
Option 3	Apply a materiality threshold to each relevant PR09 incentive mechanism individually using the same thresholds as set out above.

The potential revenue adjustment materiality threshold of 2% draws on the analysis set out as part of the consultation on WRFIM in April 2014 which analysed the forecasting error as a percentage of annual turnover by company. The analysis showed that the average annual forecast error (based on the adjusted standard error) over 2005-2015 was 2.2% for water and 2.6% for wastewater.[20] We consider that company forecasts for the blind year are likely to be more accurate, not least they were taking place part way through the year, and so we consider that a 2% materiality threshold, slightly lower than the historic variation would ensure that adjustments are only made for material differences.

The potential RCV materiality threshold of 0.5% reflects the serviceability shortfalls across water and wastewater within the PR14 final determinations, which ranged from 0.1% to 1.5% of RCV

We consider that **Option 2: apply a materiality threshold in aggregate to revenue and RCV adjustments is the most appropriate approach** as:

- it would ensure that all impacts are considered in the round and taking into account offsetting effects, and so any adjustments are only made where they have a material impact on customers;

[20] Page 19, Consultation on the wholesale revenue forecasting incentive mechanism for AMP6

- it would be a proportionate in that adjustments are only made where they are material (if adjustments were made individually then this might not be proportionate as individual measures might not reach thresholds, although in aggregate thresholds would be reached); and
- it would be consistent with the approach set out in our final determinations.

To be consistent with company ownership we consider that companies should submit their proposed adjustments for the blind year, together with their assessment of whether these adjustments meet the materiality threshold.

Table A4.4 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[21]. COPI is published quarterly by the Department of Business Innovation and Skills (BIS) with the data being provided by ONS. BIS has recently carried out a programme of work to revise the calculation of the COPI index. However following a review BIS has identified concerns with the reliability of the new indices and has therefore suspended the publication of the index. It is not known when a new index will be published. COPI indices for 2013-14 are firm for the first quarter with all later quarterly indexes being published as provisional. Provisional data has been published for the first quarter of 2014-15. A decision therefore needs to be made about the COPI that is used to calculate the CIS blind year adjustment and the timing of that reconciliation so that the adjustment for PR19 can be finalised.

The suspension of the COPI index creates 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 methodology.

We have therefore considered three options to the application of COPI to address these risks.

Option	Description
Option 1	Adjust COPI in the PR09 incentive mechanism models when the updated index is available. Under this option an adjustment may need to be made 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).

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

Option	Description
Option 2	Where 'firm' published data is unavailable, we could request companies submit their updated COPI forecast (contained within the companies' business plans) along with their annual reporting requirements. In this instance, we could use: • COPI data for 2012-13 which is firm and published, • COPI data for 2013-14 which is firm and published for one quarter, but provisional and published for three quarters, and • COPI data for 2014-15 which is provisional for one quarter. Companies would provide their updated forecasts for the remainder of the 2014-15 financial year.
Option 3	This option is as 2 above, however, we would blend the individual companies COPI forecasts and apply one set of forecasts to all CIS models.

We consider that **Option 1: Adjust COPI in the CIS models when updated data becomes available is the most appropriate approach** as:

- it would be in long term customer interests as the update occurs when accurate data is available and avoids the risk of perverse incentives from relying on company forecasts;
- it would be consistent with the final determinations and other relevant documents in that COPI would be updated in 2016;
- it would be consistent with other relevant documents in that the final update would be based on published figures rather than company forecasts; and
- it is consistent with the approach to the calculation of the CIS adjustments as it will be based on published data rather than company forecasts.

It should be noted that waiting until accurate updated COPI forecasts are available will mean that the update for the blind year will not occur until 2016 as we have indicated in the past[22]. Given that the change to price limits will not occur until 2020-25, we consider that this delay is manageable.

Options 2 and 3 could allow the reconciliation to take place in the summer of 2015 as this would use forecast COPI data rather than published data from BIS.

[22] Information notice 12/08 and was set out in the final determinations policy chapter A4

Table A4.5 Assessment of options for the update to COPI

Criteria	Option 1: ONS revised COPI	Option 2: June 2015 using company forecasts	Option 3: 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			
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. We propose that these adjustments are carried out consistent 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

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 the formal notice of the determination for each company.

There are two issues that could arise from the approach taken to setting household price control that are relevant to the reconciliation:

- 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.

- The allowed revenue control does not provide for any adjustment if a company over or under recovers the allowed revenue per customer.

The following section therefore considers whether there should be a reconciliation for differences between outturn and allowed customer revenues for the household retail control.

If a reconciliation is considered appropriate then we have considered 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

We consider that there are four main options for addressing the potential differences between outturn and allowed revenues and customer numbers.

Option	Description
Option 1	Wash-up any differences between actual and forecast customers at the end of the period (and at PR24 for the blind year). This would only deal with differences in **customers** and not revenue per customer differences.
Option 2	Wash-up any differences between actual and forecast revenues (due to differences between customer numbers and the revenues per customer) at the end of the period. As this would consider total **revenues** it would include a reconciliation of customer numbers.
Option 3	Introducing a two year time lag where **revenue allowances** are automatically adjusted for customer numbers two years after the year end when outturns are known. This would more closely follow the approach used for WRFIM.
Option 4	Do not include any further reconciliation mechanism.

We consider that **Option 2: a revenue wash-up at the end of the period is the most appropriate approach** as:

- it would avoid the risk of perverse incentives because companies would receive the revenues intended as part of the price control, avoiding the scope for creeping increases which could have a negative impact on customers (which potentially could occur under other options);
- it would provide companies with responsibility for managing revenues during the control periods (unlike a two year lagged adjustment); and
- it would be consistent with the final determinations, which would have set out a mechanism to adjust for differences in revenues or customer numbers if intended[23].

[23] 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 of the draft price control determination notice: technical appendix A6 – risk and reward).

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: 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 particular the reconciliation needs to consider whether an adjustment is required to reflect the difference in the value of receiving/paying money when the revenue over or under recovery was achieved and when this was reconciled at the end of the period. 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).

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. Consequently we consider that a financing cost adjustment should only be made if differences are material. We therefore propose to only consider a financing adjustment if there are

material differences between allowed and outturn household retail revenues. We do not consider that it is appropriate to set out the definition of material at this stage to ensure companies are incentivised to accurately match allowed revenues in each year.

A5.4 Treatment of taxation

The reconciliation of household retail revenues in PR19 will present similar issues around the treatment of taxation as the WRFIM.

We consider that there are two options for the treatment of taxation on the revenue adjustments that result from household retail.

- Option 1: Include a tax adjustment on the revenue changes that result from household retail revenues in PR19.

- Option 2: Do not include a tax adjustment on the revenue changes that result from household retail revenues in PR19.

Consistent with the approach for WRFIM we consider that **Option 2: do not include a tax adjustment on the revenue changes that result from household in PR19 is the most appropriate approach**.

This approach would ensure that companies would not receive a double allowance for taxation as follows. The revenue allowances for the 2015-20 period include an allowance for tax. 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 companies allowed revenues would be adjusted up to reflect the under recovery in period. If this adjustment to revenues was allowed to impact the tax allowances then this would increase the allowance for tax. Consequently the company would effectively be paid twice for the same tax payment. We therefore consider that a tax adjustment for revenues in household retail would not be appropriate.

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 section sets out other issues that are relevant to the PR14 reconciliation, in particular:

- land sales; and
- gain sharing mechanisms.

A6.1 Land sales

For land sales, we have continued the approach first used at PR94 where we deduct 50% of the net proceeds of qualifying land sales from the RCV.

A6.2 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.

We asked all companies introducing gain sharing mechanisms to consider the interaction with other regulatory mechanisms which form part of the framework, such as:

- the WFRIM;
- menu regulation; and
- incentives to improve performance within the period.

Subsequent conversations with companies indicates that they are considering sharing gains with customers both in the form of reductions in customer bills and through additional investment after discussion with customer engagement forums.

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 are solutions which will 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 this consultation

We have developed the PR14 reconciliation in line with our statutory duties. We would welcome responses on all parts of the recommendations that are set out in this consultation document, the PR14 reconciliation rulebook itself and the supporting spreadsheets. **We would appreciate responses around policy issues being focused around our statutory duties, for example why an alternative approach would be in customers' interests.**

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

The closing date for this consultation is **7 May 2015**.

Before this date, we intend to continue to engage and consult with stakeholders.

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.

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

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

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