IN 12/08

# Information notice

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## The capital incentive scheme (CIS) and the revenue correction mechanism (RCM) – frequently asked questions

### Introduction

Most customers in England and Wales receive their water and sewerage services from one of 22 regional monopoly companies. One of the ways we regulate these companies is to set the price and service package ('price limits') they must deliver to their customers. We last set them in 2009 for the period 2010-15. And we will set them again in 2014 for 2015-20.

As part of the price limits we set for 2010-15 we included two new financial tools to encourage the companies to deliver services efficiently and effectively to consumers and the environment. These were as follows.

- The capital expenditure incentive scheme (CIS) provides incentives for companies to put forward challenging and efficient business plans before we take our decisions on price limits. It also encourages them – after we set their price limits – to beat the assumptions we make about their costs.
- The revenue correction mechanism (RCM) is a way of sharing between companies and customers the benefits and risks of companies recovering more or less revenue than we assume when setting price limits. It also provides a financial incentive for companies to encourage consumers to use water wisely.

Since 2009 we have published a range of information about how the CIS and RCM will operate. This information is listed in:

- 'Published documents relating to the Capital Expenditure Incentive Scheme (CIS)'; and
- 'Published documents relating to the Revenue Correction Mechanism (RCM)'.

We have decided to publish this information notice to address some of the frequently asked questions we receive about both tools. If you wish to find out more about the CIS and RCM we have included links to the relevant background information under 'More information' below.

## CIS

Under the CIS, each company recovers its actual capital expenditure plus or minus a reward or penalty (an incentive allowance). The incentive allowance a company receives will depend on the difference between the capital expenditure that it forecast it would spend during 2010-15 (made in its business plan at the 2009 price review) and its actual expenditure during that period.

At the 2014 price review, we will carry out the following tasks.

- We will reconcile the incentive allowance due to each company under CIS, taking account of each company's:
  - actual capital expenditure for 2010-15;
  - its forecast expenditure assumptions for the same period; and
  - any additional income we allowed in price limits.
- We will adjust each company's

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water and sewerage sectors in England and Wales.

regulatory capital value (RCV) to reflect its actual 2010-15 capital expenditure.

These are known as 'CIS true-up adjustments'.

### Approach for calculating CIS true-up adjustments

In 2008 we published 'Capital Expenditure Incentive Scheme (CIS) – illustrative worked example' which illustrated how the CIS could work. In that worked example the RCV is adjusted for capital expenditure (capex) net of current cost depreciation ('CCD') and infrastructure renewals charge ('IRC'). This is because adjustments are made to CCD and IRC **as if** Ofwat had allowed in price limits the actual capex that each company spends.

A simpler approach is to adjust the RCV for gross capex. It removes the need to calculate the "as if" adjustments.

Our approach for calculating the CIS true-up adjustments is illustrated in 'Ofwat's approach for calculating CIS true up adjustments – flowchart'. In it we provide details of the prices ('price base') we will perform each calculation in.

### Interaction between the CIS and our other regulatory mechanisms

As part of the price limits we set in 2009, we published 'PR09/36 Change protocol for 2010-15'. This set out our framework (the 'change protocol') for dealing with the financial implications, where significant, that might arise from changes to the improvements companies are required to deliver up to 2015.

As part of the change protocol, any differences in agreed outputs will inform our decisions on:

- logging up and down;
- shortfalls; and
- interim determinations ('IDoKs').

We will adjust CIS for the impacts of logging up and logging down so companies are not penalised or rewarded for the impact of agreed changes. We will do this by adjusting both the company view and the baseline as we set out in appendix 1 of the change protocol.

We will take account of shortfalls through an adjustment to the baseline only.

We discussed the interaction between CIS and IDoKs in 'RD 13/10: Interim determinations 2010-15'. We will adjust both the company view and baseline for IDoKs as we do for logging up and down. And, because in an IDoK we reset price limits, we will adjust the capex that has been allowed in price limits.

In 'IN11/08 Changes in COPI' we published a spreadsheet to illustrate the effect of the construction output price index (COPI) on the CIS and RCV. We have updated this spreadsheet to demonstrate how IDoK, logging up and down and shortfalls would impact on the CIS.

### Treatment of 2005-10 expenditure

The CIS will operate on the entire 2010-15 period. Any expenditure related to 2005-10 activity that a company incurs after the end of that period will be treated under CIS as it will have been incurred in the period 2010-15.

To ensure that each company's RCV correctly reflects its actual expenditure during 2005-10 we have updated the capex outperformance and capping calculation for the 2005-10 period. We provided each company with its outperformance and capping calculation when we issued the updated RCV details in July 2012. We will implement the adjustment as at 31 March 2015. Following the introduction of the CIS, this calculation will not be necessary at future price reviews.

### Data availability

When we set price limits in 2014, we will not know the companies' expenditure for the final year of the 2010-15 period. A complete set of published values for COPI for 2010-15 will also not be available.

In 2014 we will:

- use a forecast for the final year expenditure, informed by the companies in their business plans; and
- make projections for COPI.

This is consistent with our approach at previous price reviews.

We will calculate the difference between the assumptions we use in setting price controls in 2014 and the actual values once all data for 2014-15 is available. We will not be able to do this until summer 2016, following the publication of final COPI values. We will calculate any adjustments to companies' revenue and RCV at that time.

### CIS true-up model

We are preparing a fully functioning spreadsheet model to perform the CIS reconciliation as illustrated in the flowchart. We will use it to calculate for each company:

- the reward/penalty revenue adjustment; and
- the RCV adjustment.

We will use the adjustments in our financial modelling at the 2014 price review.

We will publish the CIS true-up adjustments model alongside our consultation on our proposed methodology for setting price limits for 2010-15. We plan to publish this in autumn 2012.

## RCM

Under the RCM we reduce or increase the revenue requirement for a company for the next review period by the amount of revenue that company over- or under-recovers between 2010 and 2015. This will be annualised over the five years in net present value (NPV) terms.

The amount we correct for is known as the 'RCM adjustment'.

### RCM model

Alongside 'IN 11/04 Simplifying the revenue correction mechanism', which we published in May 2011, we published a spreadsheet model for how the RCM will work.

Following publication, we received queries on how it treated indexation which highlighted an error to us.

We corrected this error and published an updated model in December 2011. This was the only change we made.

### Annual statements of companies' RCM position

When we introduced the RCM at the 2009 price review we anticipated that we would publish annual statements on each company's RCM position. Since then we have changed our overall approach to regulatory reporting in line with our risk-based approach to regulation. This means we will no longer require annual submissions from the companies. So, we no longer have the information required to produce the annual statements we anticipated making.

We expect companies to track their own cumulative position using the updated RCM model. Where companies consider there are any issues that we should be aware of, we expect them to inform us, in line with our risk-based approach.

## Enquiries

If you have any questions about this information notice – or our approach to the CIS true-up adjustments and RCM adjustment – please contact dawn.harrison@ofwat.gsi.gov.uk.

# More information

'Understanding Ofwat – a glossary of the most commonly-used Ofwat terms', November 2011

'Ofwat's approach for calculating CIS true up adjustments – flowchart', July 2012

Spreadsheet model showing the effects of logging up and down, shortfalls and IDoKs on the CIS, July 2012.

'Published documents relating to the Capital Expenditure Incentive Scheme (CIS)', July 2012

'Published documents relating to the Revenue Correction Mechanism (RCM)', July 2012

'Delivering proportionate and targeted regulation – Ofwat's risk-based approach', March 2012

'IN 11/04 Simplifying the revenue correction mechanism' – including the updated spreadsheet model, May 2011

'RD13/10 Interim determinations', October 2010

'Future water and sewerage charges 2010-15: final determinations', November 2009.

'PR09/36 Change protocol for 2010-15', November 2009

'Capital Expenditure Incentive Scheme (CIS) – illustrative worked example', May 2008

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July 2012



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

Sustainable water.

**Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide consumers with a good quality and efficient service at a fair price.**