# About this document

In 'Consultation on the final 2010-15 reconciliation' we invite comments on our proposals for reconciling the incentive arrangements for companies' performance and expenditure for the 2010-15 period now that actual information is available for the complete period, including 2014-15 the last year of the price review 2009 (PR09) price control.

To the extent that the adjustments we propose are different to the assumptions we made as part of the price review 2014, the differences will mainly be taken into account at the next price review in 2019, although one, in respect of the revenue correction mechanism, could be adjusted through revenue in the period 2015-2020.

In this appendix, we set out the proposals in respect of Affinity Water. It shows how we have assessed the claims the company has made, and the basis for our proposals.

We are also publishing detailed spreadsheets containing calculations of the adjustments for each company alongside the consultation.

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# 1. Introduction

At PR09 Ofwat included a number of incentive arrangements designed to protect customers by encouraging companies to improve and deliver their services more efficiently over the period 2010-2015. The mechanisms also were intended to help companies manage uncertainty.

Many of these mechanisms required data for the last year of the price control period, 2014-15 (the blind year) to assess the final outturn for the benefit of customers, or companies, as the case may be. When PR14 was completed in December 2014, this financial year had not finished. Consequently, companies provided forecast data, which Ofwat considered and adjusted as necessary, for inclusion in the PR14 final determination.

Companies have now provided complete information and final audited spend and performance data for the whole 2010-2015 period, which we have used to update our analysis.

In reaching our proposals on the 2010-15 reconciliation, we have applied an approach that follows that previously consulted on and set out in the PR14 Reconciliation Rulebook. In ‘Consultation on the final 2010-15 reconciliation’, we:

- Recap on the approach we used at PR14 to reconcile companies’ proposed adjustments to 2015-20 price controls given companies’ performance against incentive mechanisms put in place at the last price control review (PR09); and
- Explain how and why these adjustments differ from those we made in our PR14 final determinations, and those proposed by companies.

In this appendix, we set out our proposals of the blind year reconciliation adjustments for Affinity Water resulting from the company’s actual performance during the period 2010-2015, reflecting actual data for 2014-15.

We have structured this appendix to begin in section 2 with a summary of the adjustments. In section 3 we explain each of the adjustments in turn:

- Revenue correction mechanism (RCM);
- Change protocol (logging up, logging down, shortfalls);
- Service standard outputs;
- Serviceability performance;
- 2009 agreed overlap programme; and
- Capital expenditure incentive scheme (CIS).

In addition to the incentive arrangements listed above, we also cover the 2014-15 transition mechanism in section 3.7. We summarise how and when our proposed adjustments will be implemented in section 4.

For each mechanism we outline:

- Our position as set out in PR14 final determination;
- How our proposals differ from decisions taken at PR14; and
- How our proposals differ from companies' proposals.

There are a number of other PR09 incentive mechanisms not listed above, in particular the service incentive mechanism (SIM), the opex incentive allowance (OIA) and other revenue adjustments. For these mechanisms we expected all information to be available at PR14 and so did not include these in the scope of this final reconciliation. In any case we are not aware of any reason to change these adjustments. This document makes no further reference to these.

In order to calculate the blind year adjustments, we have undertaken detailed calculations within our models for the RCM, CIS and serviceability shortfalls and the PR14 reconciliation rulebook legacy blind year model. While we provide an explanation of our interventions within this appendix, each model contains the detail of the specific calculation.

Populated models for the blind year update proposals are published alongside the consultation.

All monetary values stated in this document are in 2012-13 prices unless otherwise stated.

# 2. Summary of 2010-15 final reconciliation adjustments

Table A1 below sets out for each of the incentive tools for water and wastewater services a quantification of:

- PR14 final determination (FD) position;
- the company's view of the required adjustment (if stated in its blind year update submission); and
- our view resulting from the blind year reconciliation (BYR).

The main difference between the company and our view relates to serviceability shortfalls as set out in section 3.4.

The table shows adjustments made through revenue and those made through the RCV separately. This is because the PR09 incentive mechanisms are adjusted for in different ways. Mainly, they are adjusted through an adjustment to the RCV, however the RCM and the penalty / reward element of the CIS adjustment are both made through revenue.

**Table A1 Revenue and RCV adjustments 2015-20 (£ million)**

| | Water service | | |
|---|---|---|---|
| | **FD position** | **Company BYR view** | **Ofwat BYR** |
| **Revenue adjustments** | | | |
| RCM | 2.259 | n/a | 0.970 |
| CIS | -9.845 | n/a | -9.121 |
| Total revenue adjustments[2] | -7.586 | n/a | -8.151 |
| **RCV adjustments** | | | |
| Elements of CIS: | | | |

| | Water service | | |
|---|---|---|---|
| | FD position | Company BYR view | Ofwat BYR |
| Adjustment for actual expenditure 2010-15 | -12.932 | n/a | -15.698 |
| Adjustment for change protocol – logging up/down | 0.000 | 0.000 | 0.000 |
| Adjustment for change protocol – shortfalls | 0.000 | 0.000 | 0.000 |
| Adjustment to overlap | 0.000 | 0.000 | 0.000 |
| CIS total[2 3] | -12.932 | n/a | -15.698 |
| Serviceability shortfall | 0.000 | 0.000 | -4.734 |
| Total RCV adjustments[2 3] | -12.932 | n/a | -20.432 |

Notes:
1. The revenue and RCV adjustments are added for comparison against the materiality threshold in the PR14 reconciliation rulebook blind year model.
2. Totals may not add up due to rounding.
3. The FD position has been updated for the RCV indexation correction that will be applied separately at PR19.

The adjustments for the Change protocol and 2009 agreed overlap programme are considered separately, but both are implemented through the CIS.

# 3. Adjustments by 2010-15 incentive mechanism

## 3.1 Revenue correction mechanism

Our view for the revenue correction mechanism (RCM) adjustment is detailed in table A2 below. This shows the components of the movement from the RCM adjustment included in the PR14 final determination.

Table A3 summarises our interventions in relation to the 2010-15 RCM adjustments.

For the RCM, we apply the PR14 vanilla wholesale WACC (real; pre-tax cost of debt, post-tax cost of equity) as the discount rate. As in the final determination, the PR14 discount rate is 3.7% for Affinity Water.

**Table A2 RCM total adjustments for 2015-20 (£ million)**

| | Veolia Water Central | Veolia Water East | Veolia Water Southeast | Affinity Water |
|---|---|---|---|---|
| FD position | -1.225 | 1.844 | 1.641 | 2.259 |
| Impact of RPI changes[1] | -1.432 | -0.088 | -0.105 | -1.625 |
| Impact of updated data from company | -1.549 | 0.043 | 1.914 | 0.408 |
| Impact of other adjustments | -0.064 | -0.004 | -0.005 | -0.073 |
| Impact of Ofwat intervention | 0.000 | 0.000 | 0.000 | 0.000 |
| Ofwat BYR | -4.269 | 1.795 | 3.445 | 0.970 |
| Change from FD position | -3.044 | -0.049 | 1.804 | -1.289 |

Note:

1. The calculated movement from the RCM adjustment included in the PR14 final determination relates to actual RPI being lower than forecast at PR14 for 2014-15.

The changes shown in table A2 above will be implemented in the PR14 reconciliation rulebook legacy blind year model as discussed in section 4.

### Table A3 Interventions on proposed 2010-15 RCM adjustments

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| Forecasted 2014-15 tariff basket revenues | Our assumption for the final determination used the data the company submitted in business plan table W17 to calculate our view of the RCM adjustment. | There were inconsistencies with 2014-15 forecast revenues between business plan table W17 and Veolia Central's populated RCM model. | The company has submitted updated numbers in table W17 for 2014-15. | We have accepted the company's submission, and have not intervened. |
| FD09 assumptions – Measured Non-households' revenue for the Measured Non-household group immediately above and below the 50 Ml (megalitre) threshold | The final determination included our view of the FD09 assumptions for the inputs to the RCM model. Our view of the company's revenue assumptions for the measured non-household group immediately below and above the 50 Ml tariff basket threshold originated from the company's FD09 revenue forecasts that came from the tariff basket model, which we used for PR09. | There were differences between the company's and our view of the FD09 assumptions used in the populated RCM model. The company applied different assumptions for 'FD09 Measured Non-households' revenue for the Measured Non-household group immediately above and below the 50ML threshold' compared with our view of its FD09 assumptions for Veolia Central, Veolia South East and Veolia East. Our assumptions for the final | There has been no change from the final determination. | There has been no change from the final determination. |

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| | | determination included the FD09 revenue forecasts as contained in the PR09 tariff basket model in accordance with our published methodology 'Setting price controls for 2015-20 – further information on reconciling 2010-15 performance'. | | |
| FD09 assumptions – number of non-household billed measured properties | The final determination included our view of the FD09 assumptions for the inputs to the RCM model. Our view of the company's number of non-household properties is consistent with the company's FD09 revenue forecasts which came from the tariff basket model that we used for PR09. | The company applied different assumptions for the number of non-households billed measured properties for Veolia Central compared with our view of its FD09 assumptions. Our assumptions for the final determination corrected the company's data inconsistencies between its FD09 and its populated RCM model. | There has been no change from the final determination. | There has been no change from the final determination. |
| Outturn financial year average RPI | Our assumptions for the outturn financial year average RPI at the final determination used the data that the company submitted in business plan table A9 to calculate our view of the RCM adjustment. | There were inconsistencies with the outturn financial year average RPI between business plan table A9 and the company's populated RCM model. Our assumptions for the final determination corrected the company's data inconsistencies. | We have updated the company's forecasted RPI for 2013-14 and 2014-15 with actual RPI for 2013-14 and 2014-15. | We have updated the company's forecasted RPI for 2013-14 and 2014-15 with actual RPI for 2013-14 and 2014-15. |

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| Net revenue movement out of tariff basket in 2009-10 | Our assumption for the final determination used the data the company submitted in business plan table W17 to calculate our view of the RCM adjustment. | There were inconsistencies with the amount submitted between business plan table W17 and Veolia South East's populated RCM model. Our assumptions for the final determination were based upon the data within the company business plan table W17. | The company has submitted updated numbers in table W17 for 2014-15. | We have accepted the company's submission, and have not intervened. |
| Back-billing | We accepted the company's submission, and did not intervene. | We accepted the company's submission and did not intervene. | The company has submitted updated numbers in table W17 for years 2010-11 to 2014-15 to revise its back billing claim for the period, to bring it into line with the rules that set out in in IN11/04 'Simplifying the revenue correction mechanism' and RAG 4.04. This will benefit customers by around £1 million. | We have accepted the company's revision, and have not intervened. |

## 3.2 Change protocol (logging up, logging down and shortfalls)

Table A4 below summarises the company's view and our baseline view of total adjustments to capex included in the CIS reconciliation.

Table A5 summarises our interventions in relation to the company's proposed change protocol adjustments.

There are no changes from our final determination and there are no interventions in this area.

### Table A4 Summary of post-efficiency capex for logging up, logging down and shortfalls included in the CIS reconciliation (£ million)

| 2009-10 to 2014-15 – post-efficiency capex | Water service | | |
|---|---|---|---|
| | FD position | Company BYR view | Ofwat BYR |
| Logging up (two-sided)[1, 2] | 0.000 | 0.000 | 0.000 |
| Logging down (two-sided)[1, 2] | 0.000 | 0.000 | 0.000 |
| Shortfalls (one-sided)[1, 2] | 0.000 | 0.000 | 0.000 |

Notes:
1. We exclude serviceability shortfalls from the numbers above as they are not part of the CIS reconciliation. Instead we make direct adjustments to the RCV.
2. Changes relating to 2009-10 were implemented in full in the opening RCV at PR14 final determination.

Any changes for the five years 2010-15 included in table A4 are implemented through the CIS.

### Table A5 Interventions on proposed 2010-15 change protocol adjustments

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| There are no interventions in this area. | | | | |

## 3.3 Service standard outputs

Service standards are regulatory outputs that we set out in FD09 supplementary reports[1]. Where relevant companies reported their performance for 2014-15 on these service standards as part of their submissions for the blind year reconciliations.

In our PR14 final determination, we noted that the company had provided satisfactory evidence that it had achieved all of its service standard outputs except for the reduction of 1000 contacts per annum. The reduction of 1000 contacts per annum output related to the Blackford and Roydon Manganese removal scheme, where the company had been expected to clean 1080 km of distribution and trunk mains. We were satisfied with the limiting factors set out by the company and therefore did not apply a shortfall. However, we required the company to report progress on this activity in 2015-16.

In its blind year submission, the company did not provide any commentary on their progress in delivering this activity, so we raised a query requesting further information. The company provided an update on its progress in carrying out this cleaning activity and confirmed that the project is on track to be completed by 31 March 2017. This is reflected in an undertaking with the DWI. The company confirmed that 184km of its network at Blackford is in scope for cleaning and by 31 March 2016, 63% had been completed. At Roydon, 750km of its network is in scope for cleaning and 9% had been completed by 31 March 2016. Given the company's action plan was submitted to the DWI in September 2015 and following a period of review and detailed planning, the company only resumed the cleaning programme in January 2016, we consider that it has made good progress.

[1]In the 2009 final determination supplementary reports we said: “Both the project activity (as proposed in your final business plan) and the service standard are the defined output. You must demonstrate delivery of the stated service standard output through the June return. We recognise that companies may decide to prioritise activity differently in order to achieve the service output in a more efficient manner. All material changes to the project activity must be reported and explained through your June return.”

There are therefore no changes from our final determination and there are no interventions in this area.

## 3.4 Serviceability performance

Table A6 quantifies the value and impact of any serviceability shortfall on the RCV. Table A7 summarises our interventions in relation to the company's proposed adjustments for serviceability.

The change we have made in the blind year reconciliation work compared to our final determination, is applying a shortfall adjustment due to poor performance in unplanned supply interruptions exceeding 12 hours in Veolia Central region.

**Table A6 post-efficiency serviceability shortfall value (£ million)**

| Post-efficiency shortfall | | 2010-15 |
|---|---|---|
| Water service | FD position | 0.000 |
| | Company view | 0.000 |
| | Ofwat BYR | -4.734 |

The changes between our PR14 final determination and our proposals shown in table A6 above will be implemented in the PR14 reconciliation rulebook legacy blind year model at PR19, discussed in section 4.

**Table A7 Impact of serviceability shortfalls on the RCV**

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| Water infrastructure - Discolouration contacts per 1,000 population | For the purposes of the final determination, there was no intervention for this indicator. This was conditional upon the performance in 2014-15 being improved to a position such that it could be considered as stable. We noted we would consider a shortfall adjustment if this was not achieved. We noted that serviceability performance was due to be reviewed once actual data was available for the whole of the 2010-15 period. Any shortfalls arising from this review will be applied at the next price control. | The company (South East region) had two breaches of the upper control limit in 2011-12 and 2012-13. However, 2013-14 was below the upper control limit and 2014-15 performance was expected to improve to below the reference level. The company provided evidence on mitigation measures taken to improve performance. We considered that the improvement can be sustained and have therefore did not apply a shortfall adjustment for the final determination. However, we expected projected 2014-15 performance to be achieved. We noted if this was not achieved, we would consider a shortfall adjustment. | The actual performance for 2014-15 for the South East region is slightly worse than forecast (0.41 vs 0.37 discolouration contacts) but below the upper control limit. | We have not intervened in this area because performance for this indicator was below the upper control limit in 2014-15. |
| Water infrastructure – Unplanned supply interruptions exceeding 12 hours | - | - | The actual performance in 2014-15 for the Central region (VCE) s worse than forecast (1,553 vs. 253 properties) and it is above the upper control limit. The forecast of 253 properties was below the upper control limit at FD14.<br><br>In response to a query, the company has provided evidence it considers shows | At the 2014 final determination, the company forecast performance for this indicator for 2014-15 to lie within the control limits. Therefore we did not apply a shortfall. The actual performance for 2014-15 is now above the upper control limit, and we did not consider the Edgware Way event which led to this to be outside of the |

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| | | | that one event was outside management control. This was for a burst on a main on Edgware Way which, as a single point of failure, affected 1,175 properties.<br><br>The main was next to a gas main and the company had to wait for National Grid before excavating the main by hand.<br><br>The company also stated that there had been a manufacturing fault on the main which dated from 1967 (and had suffered from 4 bursts in the last 40 years, most recently in 2011), and that its "hotspots" programme should eradicate this single point of failure in 2016-17.<br><br>The company has also highlighted a range of activities within its management control that it is implementing in the 2015-20 period. | company's management control.<br><br>Having a water main located close to a gas main is not unusual. The location and proximity of other services should be included in the company's contingency planning. Any restriction on working practices, such as mechanical excavation, ought to have been foreseen by the company and compensated for.<br><br>In addition, the main had a history of bursts. The company appears to have understood the criticality of the asset and the risks posed by the main being a single point of failure in the network. The company should have identified and put in place appropriate measures to manage the risks identified in order to maintain the flow of services to consumers.<br><br>The company states that it is putting measures in place to address such incidents of supply interruptions, however, we do not consider that the |

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| | | | | activities that the company is implementing in the 2015-20 period suggest that the event in 2014-15 was outside its management control.<br><br>There are two breaches of the upper control limits in the last four years of AMP5. As explained in the main consultation document it is appropriate in this situation that we apply a shortfall adjustment. We are applying a shortfall adjustment of £4.734 million. |

## 3.5 The 2009 agreed overlap programme

Table A8 below confirms the 2009 agreed overlap programme assumptions. There are no changes from our final determination and there are no interventions in this area.

**Table A8 PR09 agreed overlap programme adjustments and assumptions (£ million)**

| | | 2010-15 |
|---|---|---|
| | | Two-sided adjustments for inclusion in the CIS |
| Water service | FD position | 0.000 |
| | Company BYR view | 0.000 |
| | Ofwat BYR | 0.000 |

## 3.6 CIS

Table A9 provides details of the CIS ratios and performance incentive. It also gives the monetary amounts of the CIS performance reward or penalty and true-up adjustments to allowed revenues.

Table A10 provides details of the RCV adjustments and quantifies the impact of this final 2010-15 reconciliation compared to the PR14 final determination position (updated for the indexation correction we decided to implement in February 2016).

In table A11 we summarise our interventions in relation to the company's CIS adjustments.

### Table A9 CIS true-up adjustments

| | | Veolia Water Central | Veolia Water East | Veolia Water Southeast | Affinity Water |
|---|---|---|---|---|---|
| Restated FD09 CIS bid ratio[1] | FD position | 131.482 | 142.506 | 118.681 | n/a |
| | Ofwat BYR | 131.482 | 142.506 | 118.681 | n/a |

| | | Veolia Water Central | Veolia Water East | Veolia Water Southeast | Affinity Water |
|---|---|---|---|---|---|
| Out-turn CIS ratio | FD position | 116.669 | 102.400 | 125.431 | n/a |
| | Ofwat BYR | 116.204 | 93.554 | 120.263 | n/a |
| Incentive reward/penalty (%)[2] | FD position | -4.824 | -3.235 | -6.126 | n/a |
| | Ofwat BYR | -4.755 | -1.908 | -5.059 | n/a |
| Reward/penalty (£m) | FD position | -16.863 | -0.434 | -2.071 | -19.368 |
| | Ofwat BYR | -16.687 | -0.257 | -1.714 | -18.658 |
| Adjustments to 2015-20 revenue (£m)[3] | FD position | -7.070 | -0.375 | -2.400 | -9.845 |
| | Ofwat BYR | -6.872 | -0.207 | -2.042 | -9.121 |

Notes:
1. The restated FD09 CIS bid ratio takes account of the adjustments for the change protocol (table A4) and the 2009 agreed overlap programme (Table A8).
2. The reward/(penalty) is adjusted for the additional income included in the 2010-15 determination and the financing cost on the difference between actual spend and capital expenditure assumed in the 2010-15 determination to derive the value of the adjustment to 2015-20 revenue.
3. The adjustment to 2015-20 revenue values shown in this table assumes a single year adjustment in the first year, and does not include the NPV profiling used for the final determination.

### Table A10 CIS RCV adjustments (£ million)

| | Veolia Water Central | Veolia Water East | Veolia Water Southeast | Affinity Water |
|---|---|---|---|---|
| FD position | 11.278 | -1.481 | 5.031 | 14.829 |
| Impact of indexation correction | -24.538 | -0.930 | -2.293 | -27.761 |
| Corrected FD position | -13.260 | -2.411 | 2.739 | -12.932 |

| | Veolia Water Central | Veolia Water East | Veolia Water Southeast | Affinity Water |
|---|---|---|---|---|
| Impact of updated actuals | 0.034 | -1.144 | -1.657 | -2.766 |
| Ofwat BYR | -13.226 | -3.554 | 1.082 | -15.698 |

The changes to revenue shown in table A9 and the impact of updated actuals for the RCV shown in table A10 above will be implemented through the PR14 reconciliation rulebook legacy blind year model at PR19, discussed in section 4. The indexation correction will be applied separately at PR19.

### Table A11 Interventions on proposed CIS adjustments

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| Methodology | We used the post-tax basis of the PR09 cost of capital for the discount rate when calculating the future value of the revenue adjustment in the 2010-15 period. | As explained in policy chapter A4 (PR14 FD), we changed the methodology in the CIS model. | Updated to reflect 2014-15 actual expenditure, RPI and COPI. | We have used the company's updated data and therefore have not intervened. |

| Area of intervention | What we did at FD | Why we did it at FD | What has changed in BYR | What we have done for BYR and why |
|---|---|---|---|---|
| Data inconsistencies | While the pre-tax discount rate has not been used in the final determination, we corrected the input values for the PR09 pre-tax cost of capital. | The company applied the published Ofwat methodology using its updated 2013-14 and 2014-15 information, however we noticed the pre-tax cost of capital values used by the company for calculating the future value in its CIS assessments were not aligned with the PR09 values. | There has been no change since the PR14 final determination. | There has been no change since the PR14 final determination. |

## 3.7 The 2014-15 transition programme

Table A12 confirms the company's proposed transition programme. There are no interventions in this area.

**Table A12 Transition programme in 2014-15 (£ million)**

| Net capital expenditure | FD position | Company BYR view | Ofwat BYR |
|---|---:|---:|---:|
| Water service | 5.006 | 2.134 | 2.134 |

# 4. Implementing the changes

Our PR14 reconciliation rulebook describes how we will implement the changes between our PR14 final determination and our proposals. This includes the application of the £10,000 materiality threshold to the aggregate of the revenue and RCM adjustments.

The PR14 reconciliation rulebook legacy blind year model draws together the RCM, CIS and serviceability shortfall adjustments applied in the final determination and from the blind year update, calculates the differences, performs the materiality test and preserves the present value of the blind year adjustments for those that will be implemented at PR19. Table A13 shows the output values from the legacy blind year adjustment model.

**Table A13 adjustments to be implemented (£ million)**

| | Water service |
|---|---|
| RCM revenue adjustment[1] | -1.289 |
| Total adjustment revenue carry forward to PR19 | 0.869 |
| Total adjustment RCV carry forward to PR19 | -8.995 |

Note:
1. To allow companies to manage potential volatility in customer bills, we have given them the option of implementing the RCM revenue adjustment through WRFIM in either 2017-18, 2018-19, 2019-20 or in PR19. We expect companies' responses to this consultation to propose how they want RCM adjustments to apply taking account of customer interests.

The CIS RCV indexation correction is not included in the RCV carry forward in table A13 above because it will be applied separately at PR19 in accordance with the PR14 reconciliation rulebook (section 7.2 process for adjusting CIS for both indexation and the blind year).