

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 underpinning the Competition and Markets Authority (CMA) decision on Bristol Water's appeal [2015], 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 Bristol 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.

Contents

1. Introduction	3
2. Summary of 2010-15 final reconciliation adjustments	6
3. Adjustments by 2010-15 incentive mechanism	8
4. Implementing the changes	22

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 Bristol 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 relate 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	2.552	n/a	1.843
CIS	-6.110	n/a	-6.297
Total revenue adjustments ²	-3.558	n/a	-4.454
RCV adjustments			

	Water service		
	FD position	Company BYR view	Ofwat BYR
Elements of CIS:			
Adjustment for actual expenditure 2010-15	6.934	n/a	9.101
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}	6.934	n/a	9.101
Serviceability shortfall	-4.056	0.000	-4.056
Total RCV adjustments ^{2 3}	2.878	n/a	5.046

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, which is also that of the CMA.

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. Consistent with the CMA decision on Bristol Water's appeal, the PR14 discount rate is 3.67% for Bristol Water.

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

	Water service
FD position	2.552
Impact of RPI changes ¹	-0.616
Impact of updated data from company	-0.098
Impact of other adjustments	0.004
Impact of Ofwat intervention	0.000
Ofwat BYR	1.843
Change from FD position	-0.710

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
FD09 assumptions – Tariff basket revenues	Our assumptions included our view of the FD09 assumptions taking into account the CC determination [2010]. Our view of the company's tariff basket revenues is consistent with the company's FD09/CC revenue forecasts which come from the tariff basket model that we used for PR09.	There were differences between the company's and our view of the FD09/CC assumptions used in the company's populated RCM model. Our assumptions for the final determination included the FD09/CC 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'.	There has been no change from the final determination.	There has been no change from the final determination.
FD09 assumptions – PR09 discount rate	Our assumptions included our view of the FD09 assumptions taking into account the CC determination [2010]. Our view of the company's PR09 discount rate is 4.3%.	The company had used a PR09 discount rate of 6%, which was not consistent with its FD09/CC determination of 4.3% for the company. Our assumptions for the final determination included the FD09 discount rate in accordance with our published methodology	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
		‘Setting price controls for 2015-20 – further information on reconciling 2010-15 performance’.		
FD09 assumptions – Measured non-households’ revenue for the measured non-household group immediately above and below the 50 megalitres (MI) threshold	Our assumptions included our view of the FD09 assumptions taking into account the CC determination [2010]. Our view of the company’s revenue assumptions for the measured non-household group immediately below and above the 50 MI tariff basket threshold originate from the company’s FD09/CC revenue forecasts that come from the tariff basket model, which we used for PR09.	There were differences between the company’s and our view of the FD09/CC assumptions used in the company’s 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 50MI threshold’ compared with our view of its FD09/CC assumptions. As above, our assumptions for the final determination included the FD09/CC 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’.	There has been no change from the final determination.	There has been no change from the final determination.
Number of households billed	Our assumptions for the FD09/CC determination used the data the company submitted in business plan	There were inconsistencies with the number of households billed between business plan table R3 and	The company has submitted updated numbers for table R3 for 2014-15.	We have accepted the company’s submission, and 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
	table R3 to calculate our view of the RCM adjustment.	the company's populated RCM model.		
Outturn financial year average RPI	Our assumptions for 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 table A9 and the company's populated RCM model.	Actual RPI for 2014-15 is known.	We have updated the company's forecasted RPI for 2014-15 with actual RPI for 2014-15.
PR14 discount rate	Our assumption for the PR14 discount rate at final determination was 3.6%. We have used this to calculate our view of the RCM adjustment.	The company proposed a PR14 discount rate of 5.2%. In accordance with 'Setting price controls for 2015-20 – further information on reconciling 2010-15 performance' we had used the vanilla wholesale WACC as the discount rate for PR14 for the RCM. Our assumption for the PR14 discount rate at the final determination was 3.6%.	Consistent with the CMA decision on Bristol Water's appeal [2015], the PR14 discount rate is 3.67% for Bristol Water.	Consistent with the CMA decision on Bristol Water's appeal [2015], the PR14 discount rate is 3.67% for Bristol Water.
Corporation tax rate	Our assumptions for the corporation tax rate applied in the RCM model at the final determination was the same as HMRC's published tax rates for each year.	The company had applied a corporation tax rate of 22% in 2014-15 in its populated RCM model. Our assumption for the corporation tax rate applied in the RCM model at the final determination was set at 21%.	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
Restatement of 2013-14 data	n/a	n/a	The company stated in its W17 commentary, 'Please note that a restatement of the input data to table W17 for 2013-14 is required, consistent with the footnote provided to the current cost profit & loss statement in our 2014-15 regulatory accounts'.	<p>We have accepted the company's submission, and have not intervened.</p> <p>We have calculated that the changes to historical data for the period 2010-14 results in an incremental impact on the RCM by £0.272 million in the company's favour from the FD position.</p>

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 reports¹. 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 considered the evidence provided in the company's representation and were satisfied that the service standard outputs in relation to Exceptional Items and Enhanced Service Levels have been achieved. There were therefore no interventions for the final determination. This remains our view for this final reconciliation.

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.

There are no changes from our final determination or from that of the CMA.

¹In 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."

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

Post-efficiency shortfall		2010-15
Water service	FD position	-4.056
	Company view	0.000
	Ofwat BYR	-4.056

Any 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
Serviceability – water infrastructure Unplanned interruptions to supply exceeding 12 hours	For the purposes of the final determination we applied a shortfall for deteriorating performance for this indicator. In accordance with our amended shortfall calculation methodology (see Policy Chapter A4 PR14 FD). The shortfall applied for the years 2011-12, 2013-14 & 2014-15 was capped at 1 standard deviation. We also applied a multiplication factor of 0.75 to the final shortfall value to mitigate the impact of the volatile nature of this indicator.	The company had three breaches of the upper control limit in 2011-12, 2013-14 and 2014-15 and was very close to the upper control limit in 2012-13. The company considered that the events leading to the supply interruptions were beyond their control (H&S concerns, strategic main in busy road, restricted access, operational miscommunication) and that these events should have been excluded. However, we did not consider that these events should have been	The actual performance for 2014-15, which was known at the time of the CMA reference, is worse than forecast (41,331 vs 36,306 properties).	We have applied the same shortfall adjustment of £4.1 million (post efficiency) as for the final determination and by the CMA because the company has had three breaches of the upper control limit in 2011-12, 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
	<p>The value of the applied shortfall adjustment was £4.1 million (post efficiency). The overall scale of the shortfall did not exceed 50% of the sub-service capital expenditure and therefore no further cap was applied. Our final determination shortfall was £2.1 million lower than the shortfall we applied at the draft determination.</p>	<p>excluded from the analysis, as they were within the company's control and could have been mitigated. Therefore, we applied a shortfall adjustment for deteriorating performance in this indicator.</p>		
Iron mean zonal non-compliance	<p>For the purposes of the final determination we removed the shortfall of £5.6 million applied at the draft determination following additional information provided by the company.</p>	<p>In its representation the company provided evidence to demonstrate that it had revised its Water Supply Zones in order to meet the requirements of Regulation 3 of the Water Quality Regulations. The water supply re-zoning undertaking resulted in a reduction of the number of zones from 52 (which was the basis for FD09 target levels) to 27. This became effective at the beginning of 2013. We also noted from the representation that DWI is in agreement with this reduction. Recalculating the percentage iron non-compliance on the basis of the reduced number of water supply zones,</p>	<p>The actual performance for 2014-15, known at the time of the CMA reference, is worse than forecast (0.32% vs 0.65% iron MZ non-compliance).</p>	<p>As at the final determination and the CMA's determination, we do not propose to apply a shortfall adjustment for this indicator.</p>

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
		effective 2013, showed three consecutive years of performance under the upper control limit. Therefore we removed the shortfall applied at the draft determination.		

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 or from that of the CMA.

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

		Water service
Restated FD09 CIS bid ratio ¹	FD position	127.920
	Ofwat BYR	127.920
Out-turn CIS ratio	FD position	113.935
	Ofwat BYR	114.372
Incentive reward/penalty (%) ²	FD position	-4.184
	Ofwat BYR	-4.254
Reward/penalty (£m)	FD position	-10.447
	Ofwat BYR	-10.662
Adjustments to 2015-20 revenue (£m) ³	FD position	-6.110
	Ofwat BYR	-6.297

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)

	Water service
FD position	16.275
Impact of indexation correction	-9.342
Corrected FD position	6.934
Impact of updated actuals	2.168
Ofwat BYR	9.101

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	<p>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.</p> <p>We used our assumption of the cost of capital as the discount rate when profiling the revenue adjustment in 2015-20.</p>	<p>As explained in policy chapter A4 (PR14 FD), we changed the methodology in the CIS model with respect to the discount rate used when calculating the future value of the revenue adjustment in the 2010-15 period.</p> <p>The company used its view of the discount rate (5.20%) when profiling the revenue adjustment in 2015-20.</p>	Updated to reflect 2014-15 actual expenditure, RPI and COPI.	We have used the company's updated data and therefore have not intervened.
Data inconsistencies	<p>In carrying out our assessment, we used the Competition Commission's (CC) redetermination values for the bid capex and replicated the CC's CIS ex ante ratio and additional income.</p> <p>While the pre-tax discount rate was not been used in the final determination, we corrected the input values for the CC pre-tax cost of capital.</p>	<p>The company had not reflected the CC redetermination bid capex in its CIS model. This affects the RCV adjustment and the revenue adjustment.</p> <p>The company had not correctly reflected the CC view of the pre-tax cost of capital.</p>	Updated the PR14 discount rate to reflect the CMA's determination for Bristol Water.	We have updated the PR14 discount rate to 3.67% in line with the CMA's determination for Bristol Water.

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	1.320	0.685	0.685

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	-0.710
Total adjustment revenue carry forward to PR19	-0.223
Total adjustment RCV carry forward to PR19	2.596

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).