

Consultation on the final 2010-15 reconciliation - Northumbrian response

Our response to the consultation focusses on the Totex Menu PR14 reconciliation model. In our references, we have used the following:

The October 2016 Totex Model:

<http://www.ofwat.gov.uk/wp-content/uploads/2016/10/Totex-Menu-2016-05-17-change-log-removed.xlsx>

Feb 16: Summary of formula changes to PR14 reconciliation illustrative models

http://www.ofwat.gov.uk/wp-content/uploads/2015/07/pap_tec20160216changesrecon.xlsx

Feb 16: Update to the PR14 reconciliation rulebook policy document (pages 35-36)

http://www.ofwat.gov.uk/wp-content/uploads/2015/07/gud_pro20160217pr14reconpolicy.pdf

1 The change in treatment of Adjustments to Other Cost Inclusions in Feb 2016

In the PR14 reconciliation consultation process, between the July 2015 consultation and the February 2016 outcome, there were a series of changes made to the totex menu PR14 reconciliation spreadsheet. These were summarised in the Feb 16: Update to the PR14 reconciliation rulebook policy document (pages 35 & 36).

These changes were not part of the original consultation and were simply published by Ofwat in Feb 2016. The October consultation is the first formal opportunity we have had to comment on these. We have focussed on one change that we believe warrants further discussion.

Extract from Feb 16: Update to the PR14 reconciliation rulebook policy document, page 36

Ref: Totex Menu, Other Cost Inclusions, Calcs, Rows 162 & 163.

Calculations for totex over and under performance calculation adjusted to ensure that there is no ex post adjustment that reflects differences between the actual cost and the cost included in the final determinations.

It is also covered in the Feb 16: Summary of formula changes to PR14 reconciliation illustrative models spreadsheet. The spreadsheet line 43 shows the formula changing from:

= (Actual.Totex.Water-**Actual.PDRC.Water**)/Indexation.Average-L152

To

=(Actual.Totex.Water+TransitionExp.Water-**SUM(Inputs!L60:L64)**)

/Indexation.Average-L148

This is an important regulatory decision that warrants further discussion. The decision here effectively ensures there is a 100% incentive rate for 'other totex costs'. This was not previously the case – the previous model had an effective 0% incentive rate (cost pass through) for these costs.

This decision has not been consulted on and we do not believe it is consistent with the PR14 Final Determination. We also believe that the use of either a 100% incentive rate or a 0% incentive rate would be inconsistent with the menu choice methodology and the totex incentive principles (incentives and risk sharing).

It is our view that the most logical approach is to apply the same incentive rate to 'other costs' as is applied to the general totex regime. Thus, companies have the same incentive to minimise 'other cost totex' as they do for general totex.

This, in our view is also best for customers, as, when 'other cost totex' is calculated, it is included in the Final Determination 'total allowed expenditure' and thus in customer bills. It is thus indistinguishable from general totex in function and impact. Indeed, it is only separated in the Final Determination data due to its exclusion from the initial cost assessment models.

We would be happy to discuss this further with Ofwat, as there has clearly been different approaches considered in the past. In our view, applying the same incentive rate to 'other cost totex' as 'general totex' is in line with the PR14 Final Determination, preserves incentives and shares risks & rewards in the way set out in the PR14 totex incentive regime.

2 PR14 Reconciliation Rulebook - Totex Reconciliation Model

We have a technical concern over ensuring the correct classification and treatment of 'other cash items' in the totex model. We are concerned that there could be an unintentional misclassification of expenditure in the totex model and we wish to avoid that through a clarification.

In RAG 4.06, Table 2B.20 is a line for 'other cash items – other cash items not included in the accounting charge'. For NWL in 2015-16, we attributed a large value of £25.765m for this line. Our Annual Performance Report¹ page 129 explained this as:

Other cash items reflects the difference between the accounting pension charge included within other operating expenditure, and the wholesale proportion of employer's cash contributions to the NWPS (excluding deficit reduction payments). This is a large positive value in the year because the accounting charge included an exceptional, non-cash credit reflecting changes made to future benefit, as described in note 3 of the Statutory Financial Statements.

Thus, this other cash item represent pension expenditure not related to the pension deficit recovery payments. It is thus part of menu totex, in the same way that cash expenditure in Tables W3 and S3 were part of PR14 business plan totex.

Our concern is over the interaction of the RAG4.06 definitions and the totex menu definitions, in particular the definition of **line 4B.4 – other adjustments**.

RAG4.06, Table 2B.21 shows totex including 3rd party costs, pension deficit recovery payments and other cash items (2B.20). This feeds into Table 4B.1 Actual Totex. From this, Adjusted Actual Totex 4B.7 is calculated by deducting total excluded items 4B.5, calculated as:

¹https://www.nwl.co.uk/_assets/documents/Northumbrian_Water_Annual_Report_FINAL_UPDATED_2.pdf

RAG 4.06 page 28:

Items excluded from the menu		
4B.2	Third party costs	Actual costs relating to third party services. Equal to third party capex and opex costs included in the inputs in section 3.1 of the inputs to the PR14 reconciliation rulebook wholesale totex
4B.3	Pension deficit recovery payments	Actual pension deficit recovery payments including costs capitalised and any group recharges for pension deficit costs. Equal to pension deficit recovery payments included in the inputs in section 3.1 of the inputs to the PR14 reconciliation rulebook wholesale totex spreadsheet.
4B.4	Other 'Rule book' adjustments	Other adjustments to the menu included in the inputs in section 3.1 of the inputs to the PR14 reconciliation rulebook wholesale totex spreadsheet.
4B.5	Total items excluded from the menu	The sum of lines 4B.2 to 4B.4.

It is the linking of the RAG4.06 definition of 4B.4 to the PR14 reconciliation rulebook that concerns us.

If we look below at the PR14 Reconciliation Rulebook, page 26 has what looks like the same adjustments from Actual Totex to Menu Totex. However, the definitions of what should be included in line 4B.4 are circular – RAG4.06 refers to the PR14 reconciliation rulebook, whilst the PR14 rulebook references RAG4.06. It is the reference below to 'other cash items' that concerns us – this should really be described as 'other 'rule book' adjustments' to be consistent with RAG4.06 line 4B.4.

PR14 Reconciliation Rulebook page 26:

Table 1 Calculation of totex menu

Item name	Reference in RAG 4.06	Comments (referenced to the notes below the table)
Menu totex	n/a	Note 1
Actual totex	4B.1	
Total costs excluded from the menu equals the sum of the items below:		
Third party services (opex)	4B.2	
Third party services (capex)	4B.2	
Pension deficit recovery costs	4B.3	
Other cash items	4B.4	
Disallowable costs	4B.4	Note 1

The term 'other cash items' is also used in the spreadsheet model itself – lines 63 & 69 on the inputs page, but these are not defined beyond the rulebook.

As a further complication, the **15/16 Annual Performance Report** was prepared under **RAG 4.05** guidelines, which defined 4B.4 as: *Other adjustments to the menu for example transition costs or household legacy depreciation*. There was thus no reference to cash items. In our 15/16 APR Table 4B submission, we showed line 4B.4 as zero value.

We are concerned that this small change in guidance could mean that a material totex figure that should be part of menu totex is **accidentally excluded**. **We are sure that this is not Ofwat's intention**. We note that the source for adjustments to actual totex (Line 11, page 31) is indicated as being from companies PR19 Business Plans, rather than an automatic feed from Company regulatory reports. If this is maintained, we would welcome this as it gives us a chance to explain and assure our adjustments to avoid any mistakes in interpretation.

We would be happy to discuss this further with Ofwat, as we realise our large cash expenditure is unusual and does not seem to apply to other companies in 15/16.

Northumbrian Water
November 2016