

## 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 Portsmouth 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 actual spend and performance data for the complete period 2010-2015, including 2014-15, 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 Portsmouth 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).

There are no significant differences between the company view in its submission and our view of the adjustments required for the final 2010-15 reconciliation.

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
<b>Revenue adjustments</b>			
RCM	8.992	n/a	8.802
CIS	-2.166	n/a	-2.229
Total revenue adjustments <sup>2</sup>	6.826	n/a	6.573

	Water service		
	FD position	Company BYR view	Ofwat BYR
<b>RCV adjustments</b>			
Elements of CIS:			
Adjustment for actual expenditure 2010-15	3.473	n/a	3.853
Adjustment for change protocol – logging up/down	-0.460	-0.712	-0.712
Adjustment for change protocol – shortfalls	0.000	0.000	0.000
Adjustment to overlap	0.000	0.000	0.000
CIS total <sup>2 3</sup>	3.013	n/a	3.141
Serviceability shortfall	0.000	0.000	0.000
Total RCV adjustments <sup>2 3</sup>	3.013	n/a	3.141

## 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 3.75% for Portsmouth Water.

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

	Water service
FD position	8.992
Impact of RPI changes <sup>1</sup>	-0.295
Impact of updated data from company	0.105
Impact of other adjustments	0.000
Impact of Ofwat intervention	0.000
Ofwat BYR	8.802
Change from FD position	-0.191

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 – Measured Non-households' Revenue for the Measured Non-household group immediately above and below the 50ML threshold	Our assumptions reflected our view of the FD09 assumptions. 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 come from the tariff basket model, which we used for PR09.	There were inconsistencies between the company's and our view of the FD09 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 50ML threshold' compared with our view of its FD09 assumptions. Our assumptions for the final 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'.	There has been no change from the final determinations.	There has been no change from the final determinations.
Outturn financial year average RPI	We used outturn financial year average RPI data that the company submitted in	There were inconsistencies with the outturn financial year average RPI between	Actual RPI for 2014-15 has been published.	We have updated the company's forecasted RPI for

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
	business plan table A9 to calculate our view of the RCM adjustment for the final determination.	business table A9 and the company's populated RCM model. Our assumptions for the final determination applied the data from business plan table A9.		2014-15 with actual RPI for 2014-15.

### 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.

In its blind year submission the company increased the value of its logging down claim for optional metering. We have accepted this claim and as at the final determination, have not intervened 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) <sup>1, 2</sup>	0.000	0.000	0.000

2009-10 to 2014-15 – post-efficiency capex	Water service		
	FD position	Company BYR view	Ofwat BYR
Logging down (two-sided) <sup>1, 2</sup>	-0.460	-0.712	-0.712
Shortfalls (one-sided) <sup>1, 2</sup>	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.

The 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<sup>1</sup>. 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 were satisfied that FD09 service standards (exceptional items and flood resilience) had been achieved. Therefore, we did not apply shortfalls for these outputs. 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 and there are no interventions in this area.

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<sup>1</sup>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."

**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	0.000

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
There are no interventions in this area.				

### 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.

**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 <sup>1</sup>	FD position	108.566
	Ofwat BYR	108.615

		Water service
Out-turn CIS ratio	FD position	123.211
	Ofwat BYR	123.891
Incentive reward/penalty (%) <sup>2</sup>	FD position	-6.144
	Ofwat BYR	-6.310
Reward/penalty (£m)	FD position	-2.382
	Ofwat BYR	-2.439
Adjustments to 2015-20 revenue (£m) <sup>3</sup>	FD position	-2.166
	Ofwat BYR	-2.229

## 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	5.593
Impact of indexation correction	-2.580
Corrected FD position	3.013
Impact of updated actuals	0.128
Ofwat BYR	3.141

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.  As in the final determination, the company has excluded expenditure on its leakage recovery project which is not in the scope of CIS and is wholly funded by shareholders.	We have used the company's updated data and therefore have not intervened.
Change protocol adjustments	In carrying out our assessment, we included our view of the applicable change protocol amounts.	We applied Ofwat's published methodology.	See section 3.2 and section 3.5 above.	See section 3.2 and section 3.5 above.
Data inconsistencies	In carrying out our assessment, we used the values from table A9 of the revised business plan.	We identified minor discrepancies between the RPI financial year average values in the company's populated CIS feeder model and table A9.	Updated to reflect actual RPI and COPI.	Updated to reflect actual RPI and COPI.



### 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)**

<b>Net capital expenditure</b>	<b>FD position</b>	<b>Company BYR view</b>	<b>Ofwat BYR</b>
Water service	0.000	0.000	0.000

## 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 <sup>1</sup>	-0.191
Total adjustment revenue carry forward to PR19	-0.075
Total adjustment RCV carry forward to PR19	0.154

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).