



Water 2020
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Strategy & Regulation

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Dear Sir or Madam

Consultation on the final 2010-2015 reconciliation

Thank you for the opportunity to comment on the proposals for reconciling the incentive arrangements for companies' performance and expenditure for the 2010-2015 period. We welcome the clarity that such a consultation provides. Early understanding of intended adjustments assists in ensuring the regulatory framework is transparent and stable.

In our response below, in addition to responding on the proposed treatment of Ofwat's input error in the CIS model for Thames Water, we set out our intended approach to applying the RCM adjustments, and highlight a further potential error where the proposed CIS logging adjustments are not in line with the stated policy relating to projects that straddle the two price control periods.

(a) TTT-related CIS input error

The consultation indicates that Ofwat made an error in the CIS model used in both the Draft and Final Determinations. We understand that the error was not related to a lack of clarity around the input data (for example, due to using forecasts, rather than actual data¹), but was an error over whether or not to include TTT-related data in the logging adjustments used as inputs to the CIS model.

Water customers benefit substantially from the relatively low cost of capital secured by the companies that are regulated by Ofwat. An important enabler of that low cost of capital is the transparency and stability of the regulatory framework. Ofwat is clear that the error is not related to updated data being available. Given that the AMP6 Final Determination was accepted by the

¹ For reference, the consultation notes that we provided revised data covering years earlier than the blind year for the RCM. While we did submit a small adjustment to the data that our own internal checks and balances had identified, we did not state whether or not we were requesting that the blind year reconciliation should be updated to reflect this.

company in the round, the proposed correction appears in substance to be a retrospective re-opening of the AMP6 Final Determination to correct for one particular error, thereby signalling that any and every company may be subject to any number of such further corrections as and when other errors come to light. We are concerned, therefore, that this undermines the certainty of the regulatory framework and increases the perceived regulatory risk, thereby increasing the cost of capital, and ultimately acting to the detriment of customers.

We note that this error in the Final Determination acted to increase our revenue. However, other errors act in the opposite direction. Where we have identified these we have not sought to reopen the Final Determination to correct them. For example, as Ofwat notes in the consultation, we reviewed the accuracy of our historical reporting of the sewer flooding other causes indicator. We identified errors that led to us restate the AMP5 serviceability indicator. There is a consequential error in the sewer flooding other causes performance commitment for AMP6, in that it is set more stringently than would have been the case had there not been errors in the sewer flooding data. While we have proposed an update to the AMP5 serviceability indicator, we have not proposed a corresponding adjustment to the associated AMP6 performance commitment level, on the basis that the AMP6 Final Determination was accepted by the company in the round, and should not be retrospectively re-opened.

In order to enhance the transparency and stability of the regulatory framework, we therefore consider that the 2010-2015 final reconciliation should be restricted to updating to reflect updated available data, but without correcting further errors (in either direction) that have subsequently been found in companies' Final Determinations.

(b) Intended approach to applying the RCM adjustments

We agree that allowing the final reconciliation adjustment for the RCM to be spread over different years is in customers' interests. We intend to apply the RCM adjustment in AMP6, while minimising the volatility of customer bills. Our current expectation is that the RCM adjustment would be applied in three equal parts in each of 2017/18, 2018/19 and 2019/20, although we may revise this profile, depending on any other adjustments that are required.

(c) CIS logging adjustments for projects that straddle the two price control periods

The consultation notes that "*A number of companies have raised with us the issue of how variations in the level of costs of these projects which straddle price control periods would be dealt with.*"² We discussed this issue with Ofwat in January 2016, as noted in Annex 6 of our Blind year submission document, "Tables S13 and W13 reconciliation commentary".

As shown in Annex 6, where the logging difference compared to the Final Determination is due to a timing difference between AMP5 and AMP6, rather than changes in outputs, the logging information in the submitted data tables was maintained in line with the Final Determination logging amount. As discussed with Ofwat (telephone call 13 January 2016), this approach minimises the impact of an asymmetrical treatment of such timing differences.

² "Consultation on final 2010-15 reconciliation", p34, Ofwat, October 2016

Annex 6 additionally provided alternative data showing the impact on the data tables if instead the approach was to take account of variations in the level of cost and outputs in the period 2010-2015, but not those in the period 2015-2020. As shown in Annex 6, the alternative approach, updating the logging impact to take account of variations in the level of cost and outputs in the period 2010-2015, is shown in Table 1.

Table 1: Logging impact compared to FD of reflecting variations in the level of cost and outputs in the period 2010-2015

Description	Logging up / (down) impact compared to FD of reflecting variations in the level of cost and outputs in the period 2010-2015 (pre-efficiency, 2012/13 prices, £m)	Included in proposed final reconciliation
Lee Tunnel	(8.137)	Yes
Shaft G	18.300	No
Deephams	15.462	No
Counters Creek	(5.320)	Yes
Total	20.306	

Source: Annex 6, Tables S13 and W13 reconciliation commentary, Blind year reconciliation submission

The proposed final reconciliation for Thames Water currently takes account of the adjustments for the Lee Tunnel and Counters Creek. However, it does not take account of variations in the level of cost and outputs in the period 2010-2015 for Shaft G and Deephams.

The approach currently indicated in the proposal does not, therefore, appear to be in line with Ofwat's stated approach to take account of variations in the level of cost and outputs in the period 2010-2015. To be in line with Ofwat's stated approach, the net logging would need to be increased by £18.300m for Shaft G and £15.462m for Deephams.

We would like the opportunity to discuss further the issues we raise in this letter with you, which we trust would be helpful.

Yours faithfully



Nick Fincham
Director of Strategy & Regulation