

## 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 Dŵr Cymru / Welsh 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 Dŵr Cymru / Welsh 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 the change protocol as set out in section 3.2 and 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			Wastewater service		
	FD position	Company BYR view	Ofwat BYR	FD position	Company BYR view	Ofwat BYR
<b>Revenue adjustments</b>						
RCM	17.594	n/a	11.762	15.514	n/a	10.612
CIS	-47.898	n/a	-56.135	-34.724	n/a	-36.930
Total revenue adjustments <sup>2</sup>	-30.304	n/a	-44.373	-19.210	n/a	-26.318

	Water service			Wastewater service		
	FD position	Company BYR view	Ofwat BYR	FD position	Company BYR view	Ofwat BYR
<b>RCV adjustments</b>						
Elements of CIS:						
Adjustment for actual expenditure 2010-15	128.531	n/a	156.005	32.749	n/a	49.477
Adjustment for change protocol – logging up/down	-6.255	-6.702	-6.702	49.965	47.188	39.400
Adjustment for change protocol – shortfalls	0.000	0.000	0.000	0.000	0.000	0.000
Adjustment to overlap	0.000	0.000	0.000	0.000	0.000	0.000
CIS total <sup>2 3</sup>	122.276	n/a	149.303	82.714	n/a	88.876
Serviceability shortfall	-12.645	0.000	-12.645	0.000	0.000	0.000
Total RCV adjustments <sup>2 3</sup>	109.631	n/a	136.658	82.714	n/a	88.876

## 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 3.6% for Dŵr Cymru / Welsh Water.

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

	Water service	Wastewater service	Total
FD position	17.594	15.514	33.108
Impact of RPI changes <sup>1</sup>	-2.588	-3.451	-6.040
Impact of updated data from company	-3.244	-1.451	-4.695
Impact of other adjustments	0.000	0.000	0.000
Impact of Ofwat intervention	0.000	0.000	0.000
Ofwat BYR	11.762	10.612	22.373
Change from FD position	-5.832	-4.903	-10.735

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
Revised RCM business plan tables	There were anomalies between the company's resubmitted data set, commentary and RCM model. We applied the company's resubmitted May 2014 tables in our final determination.	Following a query, the company resubmitted these tables to ensure alignment with its populated RCM model. However, the supporting commentary "Section 2 of 'SD5 – Further Information on Reconciling 2010-15 Performance'" had not been updated.	The company has submitted updated numbers for tables W17 and S17 for 2014-15.	We have accepted the company's submission, and have not intervened.
Number of households billed	We used the data the company submitted in business plan table R3 to calculate our view of the RCM adjustment.	There were inconsistencies with the number of households billed in 2013-14 and 2014-15 between business plan table R3 and the company's populated RCM spreadsheet. Our assumptions for the final determination applied the data from table R3.	<p>The company has submitted updated numbers for table R3 for 2013-14 and 2014-15.</p> <p>The company also proposed changes to the 2013-14 data in tables W17 and S17 for properties served by new appointee for water and sewerage services.</p> <p>The company stated that the 2013-14 figures as submitted in its PR14 submission were provisional forecasts as at the date of the early draft</p>	<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 £0.161 million in customers favour from the FD position.</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
			determination submission which was made before the actual numbers were finalised.	
FD09 assumptions – Measured non-households' revenue for the measured non-household group immediately above and below the 250ML threshold	We 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 250 ML tariff basket threshold originate from the company's FD09 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 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 250ML 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 determination.	There has been no change from the final determination.
Outturn financial year average RPI	We applied 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 RCM spreadsheet. Our assumptions for the final	Actual RPI for 2014-15 is known.	We have updated the company's forecasted RPI for 2014-15 with actual RPI for 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
		determination applied the data from table A9.		

### 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.

**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			Wastewater service			Total service		
	FD position	Company BYR view	Ofwat BYR	FD position	Company BYR view	Ofwat BYR	FD position	Company BYR view	Ofwat BYR
Logging up (two-sided) <sup>1,2</sup>	0.000	0.000	0.000	49.965	47.188	39.400	49.965	47.188	39.400
Logging down (two-sided) <sup>1,2</sup>	-6.255	-6.702	-6.702	0.000	0.000	0.000	-6.255	-6.702	-6.702
Shortfalls (one-sided) <sup>1,2</sup>	0.000	0.000	0.000	0.000	0.000	0.000	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**

<b>Area of intervention</b>	<b>What we did at FD</b>	<b>Why we did it at FD</b>	<b>What has changed in BYR</b>	<b>What we have done for BYR and why</b>
Meter maintenance shortfall	We accepted the company's pre-efficiency adjustments for this claim, but treated the claim as a logging down item rather than a shortfall. For inclusion in our CIS reconciliation, we applied the profile of FD09 non-infrastructure enhancement efficiencies to the annual adjustments.	We considered this to be a logging down item as it related to activity that was no longer needed – a situation that could not have been known when we set prices at PR09.	The company reports a final figure of 58,709 for the number of meters maintained in 2010-15 against the FD09 projection of 90,550. The number of meters to be logged down has therefore increased from 29,718 in their business plan to 31,841. This increases the value of the pre efficiency logging down claim from £6.429 million to £6.889 million.	As in the final determination we have not intervened in this area. We accept the company's final claim for this item.
Welsh Government mandatory build standards	We did not accept this claim.	The cost was less than 2% of the wastewater service turnover, so we considered this claim to be trivial.	There have been no changes in 2014-15. The company chose to not provide any updated information as this claim was considered trivial in the final determination.	As in the final determination we have not accepted this claim.
Adoption of private sewers – opex	We accepted the company's pre-efficiency values, but applied the profile of FD09 enhancement efficiencies rather than FD09 base efficiencies.	At the private sewers workshop on 21 May 2012 we committed to treat private sewers capex to 2020 as 'enhancement' to reduce bill impacts in the short term. As we had applied enhancement efficiency to the company's	Actual capex and opex in 2014-15 reported by the company represent slight reductions on the previous company forecasts that we accepted within the company's pre-efficiency adjustments for this claim.	As at final determinations, we have not intervened in this area and have accepted the capex as reported. The revised expenditure figures for 2014-15 have not altered our view that there is no apparent capex bias (capex/opex ratio

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
		logging up capex, for consistency, we applied enhancement efficiency to the associated opex.		remains below industry average). The capex per collapse unit cost is relatively low (whether costs are normalised or not) indicating costs claimed are efficient.
Habitats NEP (Logging up – sewerage service).	We did not intervene for this claim.		The company's business plan claim was based on its implementation of permanent solutions at a number of sites by March 2015. In the event, to meet this deadline the company implemented temporary solutions in 2014-15 before delivering permanent solutions in 2015-16 with an associated deferral of £7.379 million capex (pre-efficiency) into Year 1 of AMP6. This resulted in a lower level of capex in 2014-15 of £12.233 million compared to the business plan forecast of £21.147 million. The company considers the overall expenditure on the schemes has been in line with the change protocol submission and therefore the logging up allowance made at the FD should not be adjusted to reflect the [lower] Year 5 expenditure.	We have included a revised logging up adjustment of £12.772 million (pre-efficiency) which takes account of the company's lower actual capex in 2013-14 and 2014-15 and excludes expenditure of £7.379 million incurred in 2015-16 implementing permanent solutions for these 5 additional outputs. We are not convinced that the company's actions delivered equivalent outputs to customers. We are concerned that implementing both temporary and permanent solutions could have increased costs inefficiently. Therefore we are only logging up expenditure incurred in the period 2010-15.

<b>Area of intervention</b>	<b>What we did at FD</b>	<b>Why we did it at FD</b>	<b>What has changed in BYR</b>	<b>What we have done for BYR and why</b>
			<p>During preparation of its 2013-14 year end accounts (which were finalised after submission of its revised business plan in May 2014), the company identified that actual capex in 2013-14 was £0.299 million lower than that reported in its revised business plan. The company also identified that the majority of the capital costs related to these schemes in 2013-14 was maintenance rather than enhancements expenditure. The impact of this reduces the value of the pre-efficiency logging up in 2013-14 from £2.144 million to £0.539 million which the company has included in its commentary.</p>	

We have not intervened in either meter maintenance logging down claim (water service) or the adoption of private sewers logging up claim (sewerage service).

### **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 the company had achieved its water service standard outputs in respect of resilience and sewerage service standard outputs in respect of pollution, odour and enhanced digestion and therefore we did not intervene to apply a shortfall. 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.

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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."

There are no changes from our final determination.

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

Post-efficiency shortfall		2010-15
Water service	FD position	-12.645
	Company view	0.000
	Ofwat BYR	-12.645
Wastewater 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
Water infrastructure - Unplanned supply interruptions 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), the shortfall applied for the years 2011-12,	The company had three breaches of the upper control limit in 2011-12, 2012-13 and 2013-14. The 2014-15 forecast was also above the upper control limit. We considered the company's representation and its proposal for a reduced	Actual performance in 2014-15 in this indicator is better than forecast (2,375 vs 4,258 properties) but still above the upper control limit.	We have applied the same shortfall adjustment of £12.6 million (post efficiency) as for the final determination because the company has had four breaches of the upper control limit in 2011-12, 2012-13, 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>2012-13, 2013-14 and 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 proposed a shortfall of £7.2 million (post efficiency), however the value of the applied shortfall adjustment was £12.6 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.</p> <p>Our final determination shortfall was £19.7 million lower than the shortfall we applied at the draft determination.</p>	<p>shortfall of £7.2 million (post efficiency). We considered this value did not sufficiently represent the scale of failure. We also excluded from the performance an incident that took place in 2014 resulting in 1,891 properties being interrupted for more than 12 hours – we agreed with the company that the incident could not have been foreseen and was out of its direct control. However, despite the application of this exclusion, performance in 2013-14 remains above the upper control limit and the 1 standard deviation cap. Therefore the exclusion had no impact on the value of the shortfall.</p>		

### 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
Wastewater 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	Wastewater service	Total service
Restated FD09 CIS bid ratio <sup>1</sup>	FD position	105.860	105.499	n/a

		Water service	Wastewater service	Total service
	Ofwat BYR	104.848	106.565	n/a
Out-turn CIS ratio	FD position	137.342	119.193	n/a
	Ofwat BYR	141.607	121.269	n/a
Incentive reward/penalty (%) <sup>2</sup>	FD position	-10.100	-5.330	n/a
	Ofwat BYR	-11.528	-5.719	n/a
Reward/penalty (£m)	FD position	-54.338	-32.856	-87.193
	Ofwat BYR	-62.350	-34.937	-97.287
Adjustments to 2015-20 revenue (£m) <sup>3</sup>	FD position	-47.898	-34.724	-82.622
	Ofwat BYR	-56.135	-36.930	-93.065

## 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	Wastewater service
FD position	157.931	120.421
Impact of indexation correction	-35.655	-37.708
Corrected FD position	122.276	82.714
Impact of updated actuals	27.027	6.163
Ofwat BYR	149.303	88.876

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 with respect to the discount rate used when calculating the future value of the revenue adjustment in the 2010-15 period.  The company used the PR09 pre-tax cost of debt as the discount rate when calculating the future value of the revenue adjustment.	Updated to reflect 2014-15 actual expenditure, RPI and COPI.	We have used the company's updated expenditure data and therefore have not intervened.
Change protocol adjustments	In carrying out our assessment, we included our view of the applicable change protocol amounts for water and wastewater.	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 values from tables A9.	We identified minor inconsistencies between the revised business tables and the company's populated CIS model on the RPI and COPI	Updated to reflect actual RPI and COPI.	Updated to reflect actual RPI and COPI.

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
		financial year values for 2013-14 and 2014-15.		

### 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	2.649	0.708	0.708
Wastewater service	3.410	1.400	1.400

## 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	Wastewater service
RCM revenue adjustment <sup>1</sup>	-5.832	-4.903
Total adjustment revenue carry forward to PR19	-9.831	-2.632
Total adjustment RCV carry forward to PR19	32.255	7.355

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).