

October 2016

Trust in water

# **Consultation under section 13 of the Water Industry Act 1991 on proposed modification to condition B Licences for 17 water companies**

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## About this document

This document invites comments on the proposal of the Water Services Regulation Authority (Ofwat) to modify condition B (Charges) of the conditions of appointment (licences) of the following water companies<sup>1</sup>:

- Anglian Water Services Limited
- Dwr Cymru Cyfyngedig
- Northumbrian Water Limited
- Severn Trent Water Limited
- Southern Water Services Limited
- South West Water Limited
- Thames Water Utilities Limited
- United Utilities Water Limited
- Wessex Water Services Limited
- Yorkshire Water Services Limited
- Affinity Water Limited
- Bristol Water plc
- Dee Valley Water plc
- Portsmouth Water Limited
- South East Water Limited
- South Staffordshire Water plc
- Sutton and East Surrey Water Plc

The purpose of the proposed modification is to enable water companies to levy charges to recover shortfalls in revenue in previous charging years that are calculated in accordance with the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM).

Under section 13 of the Water Industry Act 1991 (WIA91), we are able to modify the conditions of a company's licence if it agrees to the change we are proposing to make.

This document and the attached appendix is a Notice under section 13 of the WIA91.

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<sup>1</sup> By "water companies" we mean companies holding appointments as water undertakers and/or sewerage undertakers under the Water Industry Act 1991.

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## 1. Responding to this consultation

We invite stakeholders to comment on our proposed modification by November 9 2016. Companies should also indicate their acceptance or otherwise of the proposed modification by this date. You can email your responses to [peter.jordan@ofwat.gsi.gov.uk](mailto:peter.jordan@ofwat.gsi.gov.uk) or post them to:

Peter Jordan  
Ofwat  
Centre City Tower  
7 Hill Street  
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If you wish to discuss any aspect of this document, please direct your enquiry to Peter Jordan on 0121 644 7512 or by email to [peter.jordan@ofwat.gsi.gov.uk](mailto:peter.jordan@ofwat.gsi.gov.uk).

We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

## 2. Background

We introduced WRFIM at the 2014 price review (PR14) to replace the 2009 price review (PR09) revenue correction mechanism (RCM). We introduced WRFIM to improve companies' revenue forecasting within the new flexible wholesale revenue controls. We consulted on WRFIM in our 'Consultation on the wholesale revenue forecasting incentive mechanism for AMP6', published in April 2014. We further clarified our approach in 'Draft price control determination notice: technical appendix A6 – risk and reward', and responded to companies' concerns on the mechanism. We finalised our approach in 'Final price control determination notice: policy chapter A7 – risk and reward', taking account of company responses to the April consultation and company representations following the draft determinations.

The purpose of the mechanism is to reduce the impact of significant changes in customer bills arising from revenue forecasting variances by:

- adjusting companies' allowed revenues each year to take account of differences between actual and projected revenues; and
- incentivising companies to avoid revenue forecasting errors by applying a penalty to variations that fall outside the set revenue flexibility threshold.

In the rulebook published in July 2015, we explained we had identified an issue on the consistency between the original WRFIM formula and the licence.

In summary, the licence allows price controls to limit the annual change in allowed revenue and does not explicitly reference the WRFIM formula, or any adjustment to revenues to make up for previous under- or over-recovery. When a company under recovers in year  $t-2$ , the WRFIM uplifted the allowed revenue for year  $t$ , taking into account that previous under-recovery. This means the company is expected to make up the previous under-recovery and collect more revenue than allowed by the limit set out in the price control. If the company did not make up this previous under-recovery, then it could be liable for a penalty under the WRFIM formula.

We do not consider that the licence prevents a company that had over-recovered revenue from choosing to set prices below the price control limit to offset this previous over recovery.

Therefore, in our July 2015 rulebook we consulted on alternative options to address the inconsistency by changing either the licence or the WRFIM formula

In February 2016<sup>2</sup>, we summarised the range of views expressed and our decision that we would allow each company to choose their preferred solution. This gives them the flexibility to choose the option that best suits their business and the interests of their customers. We asked companies to confirm their decision. Since this date, all companies have indicated that they would like to have a licence modification.

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<sup>2</sup> PR14 reconciliation rulebook policy document, [http://www.ofwat.gov.uk/wp-content/uploads/2015/07/gud\\_pro20160217pr14reconpolicy.pdf](http://www.ofwat.gov.uk/wp-content/uploads/2015/07/gud_pro20160217pr14reconpolicy.pdf)

### **3. What is the effect of the changes that we are proposing?**

We propose amending the licence for companies so that it is clear that in 2017-18, 2018-19 and 2019-20 water companies can levy charges to recover shortfalls in revenue in previous charging years that are calculated in accordance with the WRFIM, regardless of the annual limits on the change in revenue in the price controls for wholesale activities that we set for the 2015-20 period. The relevant version of the WRFIM for these purposes is that published by Ofwat in October 2016 (so that companies have certainty over the calculations that will be applied).

The modification would cease to have effect at the end of the current price control period and will not apply to the next price control period beginning on 1 April 2020.

The modification will enable companies to correct revenue forecasting errors more quickly than would be possible without a licence modification. Companies will be able to make good under-recoveries of revenue during the 2015-20 period.

Companies that accept the licence modification may experience a penalty if they under-recover revenue and then fail to recover this revenue in line with the operation of the WRFIM formula.

An illustrative example of the wording of the proposed modification to Condition B is stated below:

“For the avoidance of doubt, sub-paragraph [8.1/9.1<sup>3</sup>] does not prevent the Appointee from levying charges to recover a Relevant Shortfall in a Relevant Charging Year regardless of the limit on the change in revenue allowed to the Appointed Business in respect of the Wholesale Activities concerned. For the purposes of this sub-paragraph:

(a) a “Relevant Charging Year” is a Charging Year in the period from 1 April 2017 to 31 March 2020; and

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<sup>3</sup> The lower number refers to Condition B of the licences of water companies that only hold appointments as water undertakers (water only companies) and the higher number refers to Condition B of the licence of water companies that hold appointments as both water undertakers and sewerage undertakers (water and sewerage companies).

(b) a “Relevant Shortfall” is any positive amount (RFIMt) calculated for the Relevant Charging Year in accordance with the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) formula published by the Water Services Regulation Authority in October 2016.

This sub-paragraph shall cease to have effect and be deleted on 1 April 2020.”

## **4. Why do we need to make the changes we are proposing?**

The WRFIM is designed to incentivise water companies to avoid revenue forecasting errors by applying a penalty to variations that fall outside the set revenue flexibility threshold. It also adjusts companies' allowed revenues each year to take account of differences between actual and projected revenues.

The changes will enable companies to make up a previous under-recovery of revenues during the 2015-2020 period, instead of having to wait until 2020-25.

We consider that a licence modification that ensures that the WRFIM can operate as intended at PR14 will maximise the opportunities for companies to take ownership and accountability for managing cash flows between years for the benefit of customers. Customers in turn are likely to receive smoother movements in bills between years.

Companies that do not accept the licence modification will operate on the amended WRFIM formula published by Ofwat on 5 October 2016 that will not include a penalty if they do not make up a previous under-recovery. This will remove any possibility that companies could be penalised for complying with their licence. However, we think it is in all stakeholders' interests for changes to be made during the 2015-2020 period, instead of in the 2020-25 period.

Where companies have not fully recovered prior over or under-recoveries during the period, these (and any associated penalties) will be reconciled and added to allowed revenues in the next price control period.

## **5. Next steps**

We would like responses to this document, including formal agreement to our proposals from those companies that wish to proceed with the licence modification, by 9 November 2016.

Subject to the responses to this consultation of the agreement of the companies concerned, we expect to amend companies' licences by 15 December 2016.