

WATER SERVICES REGULATION AUTHORITY (OFWAT)

Modification of the Conditions of Appointment of 16 water companies

Following the [notice of the proposal](#) published on 11 October 2016 (issued under section 13 of the Water Industry Act 1991), this notice confirms that Ofwat has now modified Condition B (Charges) of the appointments of 16 water companies to reflect the Wholesale Revenue Forecasting Incentive Mechanism.

The modifications have been made for 10 companies holding appointments as both water and sewerage undertakers (referred to as 'water and sewerage companies' for the purpose of this notice):

- Anglian Water Services Limited, Dŵr 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 and Yorkshire Water Services Limited.

The modifications have also been made for 6 companies that only hold appointments as water undertakers (referred to as 'water only companies' for the purpose of this notice):

- Affinity Water Limited, Bristol Water plc, Portsmouth Water Limited, South East Water Limited, South Staffordshire Water plc and Sutton and East Surrey Water plc.

Ofwat has, with the agreement of the companies concerned, modified Condition B for water and sewerage companies by inserting an additional subparagraph 9.1A and for water only companies by inserting an additional subparagraph 8.1A (as set out in the Schedule below). The modification will have effect from 15 December 2016.

Dee Valley Water plc, a water only company, did not agree to the proposal set out in the section 13 notice and Condition B of its appointment has not been modified. The text of the modifications to the conditions of appointment for the 16 affected water companies can be viewed on our website. The background and the reasons for the modification are set out below.

Background

The Wholesale Revenue Forecasting Incentive Mechanism was introduced at the 2014 price review (PR14) to replace the 2009 price review (PR09) revenue correction mechanism (RCM).

The purpose of WRFIM was to improve companies' revenue forecasting within the new flexible wholesale revenue controls¹ and specifically to reduce the impact of significant changes in customer bills arising from variances in actual and forecasted revenues. To achieve this, the WRFIM allows the adjustment of companies' revenues each year, within the control period, to take account of differences between actual and projected revenues; and incentivises companies to avoid revenue forecasting errors by applying a penalty to variations that fall outside the set revenue flexibility threshold.

The potential for a financial penalty for companies arises if there is more than a 2% difference between their recovered and their adjusted allowed revenues. The adjusted allowed revenues in the WRFIM include an adjustment to reflect previous revenue under- or over-recovery, which is implemented 2 years after the charging year.

However, we explained in the rule book published in July 2015 and the notice published in October 2016 that we had identified an inconsistency between Condition B and WRFIM.

The inconsistency between the licences and WRFIM

Price controls limit the annual change in allowed revenue, but Condition B did 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 Condition B prevents a

¹ 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.

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 Condition B or the WRFIM formula. All companies indicated their preference for a licence modification.

Reason for the modification

The purpose of the modification is to ensure that it is clear that in 2017-18, 2018-19 and 2019-20 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 which appears in the Ofwat PR14 reconciliation rulebook, published 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. We consider that this maximises the opportunities for water 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.

Schedule

Condition B: Charges

Part III (Periodic Reviews) of Condition B (Charges) has been amended as follows -

After sub-paragraph [8.1/ 9.1²], the following text has been inserted as sub-paragraph [8.1A/9.1A]

“For the avoidance of doubt, sub-paragraph (8.1/9.1) 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

(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.”

² The lower paragraph number refers to Condition B of the appointments of water only companies and the higher number refers to Condition B of the appointments of water and sewerage companies.