

24 March 2017

Trust in water

# Further consultation on the 2010-15 final reconciliation for the change protocol and overlap mechanisms

[www.ofwat.gov.uk](http://www.ofwat.gov.uk)

**ofwat**

## **About this document**

In this document we invite further comments on our proposals for reconciling the incentive arrangements for companies' performance and expenditure for the 2010-15 period. It follows our earlier consultation on our draft reconciliation on 5 October 2016.

We have reflected on the responses we received to our earlier consultation. We have revised our proposals for the reconciliation related to the change protocol and 2009 agreed overlap programme incentive mechanisms. We have therefore provided this further opportunity to comment on these revisions by 31 March 2017.

Other proposed reconciliations, including those related to the capital incentive scheme (CIS) and serviceability, are outside the scope of this further consultation. This does not pre-judge the outcome of ongoing work to finalise our proposed reconciliations in other such areas for a few individual companies.

We expect to confirm our view of the final reconciliation for the 2010-15 period, for all of the incentive mechanisms, by summer 2017. We will make any adjustment at the next price review in 2019.

## **Contents**

|   |    |
|---|----|
| 1. Overview .....   | 3  |
| 2. Change protocol (logging up, logging down and shortfalls)..... | 6  |
| 3. The 2009 agreed overlap programme.....                         | 18 |
| 4. Next steps .....   | 22 |

## 1. Overview

- 1.1 At the 2009 periodic review (PR09) we 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 were also intended to help companies manage uncertainty.
- 1.2 Many of these mechanisms required data for the last year of the price control period, 2014-15 (the blind year), to assess the final financial payments between companies and customers. When the 2014 periodic review (PR14) was completed in December 2014, this financial year had not finished. Consequently, companies provided forecast data, which we considered and adjusted as necessary, for inclusion in the PR14 final determination.
- 1.3 Companies have now provided complete information and final audited spend and performance data for the whole 2010-2015 period. We have used this to develop our view of the final reconciliations for the PR09 incentive mechanisms, to be implemented at the next price review in 2019 (PR19).
- 1.4 On 5 October we consulted on our draft reconciliation. We:
  - recapped on the approach we used at PR14 to reconcile incentive mechanisms; and
  - explained how and why the adjustments we proposed were different from either those we had made in our final determinations in December 2014 (FD14), or those proposed by companies in February 2016.
- 1.5 We received a response from each of the 17 water companies that were the subject of our consultation.
- 1.6 On 8 December we published [Revenue correction mechanism 2010-15 final reconciliation](#). We published our decisions on the final reconciliation for the revenue correction mechanism earlier as they had the potential to affect revenue limits for 2017-18. Therefore we needed to allow companies sufficient time to consider the appropriate charges for 2017-18.
- 1.7 Some of the consultation responses suggested alternatives to our proposed approach to the reconciliations. In reflecting on these responses we have revised our proposals for the change protocol and 2009 agreed overlap

programme incentive mechanisms. As this is a revision in how we intend to apply policy we have provided a further opportunity for stakeholders to comment.

- 1.8 For the change protocol, our draft reconciliation used updated information on company costs, even where there was no difference between the delivery of outputs expected at FD14 and those delivered during the 2010 to 2015 period. However, our established policy and practice (prior to the draft reconciliation) is that action for logging up, down and shortfalling is principally dependent on changes in output delivery for the 2010-15 period and not on changes in costs. We have therefore modified our approach to the reconciliation for the change protocol to focus on output delivery. Chapter 2 sets out our proposed approach to the change protocol and the impact on individual companies.
- 1.9 In addition, we consider that we should not include further adjustments for the 2009 agreed overlap programme in this final reconciliation. We explain in chapter 3 why all such relevant adjustments had been completed at FD14.
- 1.10 This document sets out our revised proposals of the adjustments that are required. The revisions we have made ultimately impact the CIS reconciliation. The overall impact of the changes we propose would increase revenue adjustments compared to those we set out in our draft reconciliation. These changes are set out in the table below. We will make CIS revenue adjustments at the next price review, PR19.

**Table 1: Impact of revisions on CIS revenue adjustment**

| Impact on CIS Adjustments (£m 2012-13 prices) | Water Service | Wastewater service |
|---|---------------|--------------------|
| Dŵr Cymru                                     |               | 1.5                |
| Northumbrian Water                            |               | 1.4                |
| Southern Water                                | 0.1           | 0.2                |
| Thames Water <sup>1</sup>                     |               | 0.1                |
| United Utilities                              |               | 1.1                |
| Yorkshire Water                               |               | 0.03               |

**Note** <sup>1</sup> The impact for Thames Water is subject to any action required for Counters Creek 2010-15 outputs as we explain in chapter 2.

- 1.11 As set out in Chapter 4 we welcome any comments you may have on these revised proposals by 31 March 2017. Please email your responses to [PR14reconciliation@ofwat.gsi.gov.uk](mailto:PR14reconciliation@ofwat.gsi.gov.uk). We intend to publish all written

responses that we receive on our website alongside the final 2015-20 reconciliation.

- 1.12 We will consider responses and expect to confirm our view of the final reconciliation for the 2010-15 period by summer 2017, which will be implemented at PR19. This will include the capital incentive scheme (CIS) and serviceability.

## **2. Change protocol (logging up, logging down and shortfalls)**

2.1 This chapter sets out our revised proposals for the reconciliation for the change protocol. We consider our proposals would have small financial consequences for five companies. This impact would not apply until PR19. The five companies are:

- Dŵr Cymru;
- Northumbrian Water;
- Southern Water;
- Thames Water; and
- Yorkshire Water.

2.2 We do not consider there to be an impact for any other company.

2.3 This chapter sets out the background of the change protocol, summarises the responses we had to our consultation on the draft reconciliation and then explains how we have considered these in reaching our revised proposals.

### **Background**

2.4 The change protocol for 2010-15 was published in November 2009 to provide a framework to deal with material changes in the investment programme. The operation of the change protocol for 2010-15 impacts the capital incentive scheme (CIS) which is explained in chapter 4 of our October 2016 consultation.

2.5 At PR09, we set the CIS baseline at the efficient capital expenditure that a water company required in the 2010-15 period. We compare a company's actual expenditure with our CIS baseline to assess if there is any under or out performance.

2.6 At PR09, the company set out its view of the expenditure it required. We use the ratio between the PR09 company view of efficient expenditure and the CIS baseline, the CIS ratio, in calculating how to share out or under performance between customers and the company. We set out how we do this at PR09.

- 2.7 The change protocol for 2010-15 sets out how we make adjustments to appropriately reflect changes in circumstances, before calculating how any under or out performance is shared. There are two sorts of adjustments:
- logging up and down; and
  - shortfalls.
- 2.8 Logging up and down adjustments are ‘two-sided’ adjustments, where we adjust both the PR09 company view of efficient expenditure and our CIS baseline. This allows legitimate material changes that companies report in the investment programme to be recognised without affecting how under or out performance is shared. If we and the company agree on the financial impact of the change, there is no net impact on the CIS ratio. We only make adjustments for non-trivial changes to delivery requirements (>2% of relevant service turnover).
- 2.9 Shortfalls are ‘one-sided’ adjustments, where we adjust our expenditure assumption for the CIS baseline only, increasing the CIS ratio. This changes how under or outperformance is shared. We do this where there are obligations, funded at PR09, which have not been delivered by the company. To protect customers we make adjustments wherever companies fail to deliver their outputs regardless of the value of the failure.
- 2.10 This chapter deals with change protocol issues. This excludes serviceability shortfalling. This was discussed in [chapter 3](#) of our October 2016 consultation document.
- 2.11 We set out our draft reconciliation for the change protocol in [chapter 5](#) of our consultation document. In this we recapped on the approach we used at the 2014 price review (PR14) and explained how and why our draft reconciliation differed from those we made in our final determinations (FD14), and those proposed by companies.

## Consultation responses

- 2.12 Of the responses only five made specific reference to the change protocol. Southern Water accepted the adjustments and Severn Trent Water did not seek to dispute any of them. United Utilities also did not propose any revisions.
- 2.13 Thames Water noted in its representations that in the draft reconciliation we took account of the lower than expected expenditure incurred in 2010-15 for the

Lee Tunnel and Counters Creek. However, we did not take account of variations in the level of cost and outputs in this period for Shaft G and Deephams. In its representations Thames Water suggested that we had not treated relevant claims consistently. It considers that if we take account of the lower than expected expenditure incurred in the 2010-15 period on Counters Creek and the Lee Tunnel, then to be consistent, we need to increase the net logging up and down to take account of additional expenditure incurred in the 2010-15 period for Shaft G (£18.3 million). The additional expenditure incurred in the 2010-15 period for the Deephams project should also be taken into account as part of the 2009 agreed overlap programme (see chapter 3).

- 2.14 Welsh Water requested that our proposed adjustment to Welsh Water's logging up claim relating to the Habitats National Environment Programme be removed, because it had delivered the outputs.

## **Consideration of responses**

- 2.15 In the light of consultation responses we have reviewed our draft reconciliation. We propose to change the draft reconciliation to make it consistent with our established policy and practice in the 2010-15 period.
- 2.16 Our policy and practice has been that we make adjustments for logging up, down and shortfalling if the outputs that companies have delivered are different to what they were supposed to deliver in the 2010-15 period. Where outputs change, we use the logging up and down and shortfalling mechanisms to adjust the aggregate CIS baseline view of efficient cost. This impacts the CIS mechanism, by changing how any under or over performance on capital delivery is shared with customers, as explained in the background section above.
- 2.17 Comparing actual costs against an independent benchmark provides incentives for a company to be efficient. If the company outperforms our efficiency assumptions it shares a proportion of any savings made or bears a proportion of any inefficient costs incurred. We should not amend the independent benchmark with actual costs, otherwise there can be no difference and the company would know it would receive whatever it spent. This would not promote efficiency.
- 2.18 Where companies provided updated information on costs we used this in our draft reconciliation, even where there was no difference between the delivery of outputs expected at FD14 and what actually occurred in the 2010 to 2015

period. We now consider that our draft reconciliation for the change protocol did not reflect our policy and practice and have now revised our proposals. Our revised approach follows our established policy and practice.

2.19 The remainder of this chapter explains in more detail:

- what our previously established policy and practice was in using the change protocol;
- why we consider a change is required to that which we set out in our draft reconciliation;
- how our revised proposal impacts companies; and
- the ultimate financial impact it would have on companies.

## Consideration of established policy and practice

2.20 The decision to have a change protocol based on changes in outputs in the 2010-15 period was set out in the [PR09 methodology](#).

**“Consumers expect each company to deliver all the outputs associated with price limits. Where an output included is not delivered because it is no longer required or for reasons outside a company’s control, we will ‘log down’ associated capital expenditure.**

**Where a company has no legitimate excuse for failing to deliver an output, we will shortfall that company (that is, make a financial adjustment to remove all benefit from the associated price limit allowance). We will also consider the nature of the undelivered output when deciding on additional measures – which could include a requirement to deliver at shareholder expense, or a financial penalty under our existing powers.”**

2.21 The [PR14 methodology](#) set out the approach to both reconcile the 2010-15 period and to complete the reconciliation of the 2005-10 period (ie 2009-10).

**“The change protocol – and associated tools such as logging up, logging down and shortfaling – is the mechanism we have used over 2010-15 to manage changes in the outputs companies deliver, and to encourage long-term sustainable investment.**

**We expect companies to set out and demonstrate how they have delivered their PR09 final determination outputs and obligations for 2010-2015, incorporating final adjustments and reconciliations for outputs in 2009-10. Where the companies have not delivered, or are at significant risk of not delivering, these outputs we would expect the company to suggest appropriate shortfalling and logging down. Similarly, where a company has had to deal with appropriate (and non-trivial) new obligations, it should consider these for logging up.”**

2.22 In our 2009 final determinations (FD09), we had expectations of what would be delivered in the final year of the 2005-10 period (2009-10). We set these out in the FD09 supplementary reports. In line with our PR14 methodology, we reviewed if these outputs were delivered. If outputs were as expected we took no further action. It was only if there was a change in output that any adjustment was made. We consider this to be the established policy and practice.

### **Application of established policy and practice to the 2010-15 period**

2.23 In [April 2014](#) we provided further detail on our approach on completing the final reconciliation of the 2010-15 period:

**“The change protocol and serviceability review will require companies to submit information identical to that sought through PR14 about the delivery of the FD09 outputs and serviceability measures for 2014-15. Any material differences between FD09 outputs and actual deliverables will then be reconciled.”**

2.24 The current issue has arisen from how we interpreted a statement in the [Reconciliation Rulebook](#) for the draft reconciliation. We set out:

**“The blind year reconciliations will be performed using the existing legacy mechanism models, as published on the Ofwat website at the final determination. The reconciliations will compare:**

- **the adjustments that were made to Revenue and / or RCV at PR14 as published in the company specific appendix final determination documents with:**
- **the adjustments that would have been made had there been complete information for the full period, (including 2014-15) at the time of the final determination.”**

2.25 The high level approach in the reconciliation rulebook explains well our overall intent for the 2010-15 final reconciliation for the RCM and CIS incentive

mechanisms. For CIS, as set out in chapter 4 of our consultation document, we have updated actual capital expenditure from that forecast at FD14, including adopting latest information on inflation.

- 2.26 We note at FD14 there was not a published model for change protocol. Instead the result of logging up and down and shortfalling is an input into the CIS model.
- 2.27 Where companies provided actual expenditure in their February 2016 submission we used this for logging up and down in the October 2016 draft reconciliation in place of the figures we had used at FD14. In doing this we revised the logging up and down figures. We now consider that this was inappropriate and based on an incomplete interpretation of the reconciliation rulebook. In focusing on actual expenditure, rather than output delivery, we did not take into account our established policy and practice that we stated we would apply in our PR09 and PR14 methodologies and FD14 documentation.
- 2.28 As explained in the background section above, the corrections we have set out above in logging up, logging down and short falling impact the CIS reconciliation. This compares our CIS baseline view of efficient costs with the actual expenditure incurred by companies and calculates how any over or under performance is shared with customers. The CIS baseline expenditure figure should reflect the efficient allowed cost and is not meant to be the actual expenditure. One problem with using actual expenditure in the CIS baseline is that a water company might then have capital expenditure that was inefficiently incurred which would then be allowed as part of the logging up/down process. Equally it would remove any benefit from companies of making efficiency savings. This would remove the incentive for companies to deliver these outputs efficiently and thus not protect customers.
- 2.29 In other words, rather than focus on outputs to be delivered by a given date, the consultation on our draft reconciliation took companies actual expenditure and treated that as being subject to a “truing up” for the blind year. This was inconsistent with our previous policy and practice.

## **Consideration of company specific issues**

- 2.30 Following the correction to our approach, we have gone back to each of the proposed adjustments for the change protocol to review whether the delivery dates of outputs have been met or are likely to be met. If the output is delivered on time no action is required in the final reconciliation. In these cases we have

reverted to the adjustments made at FD14 for the output. If delivery dates are missed we should then consider what action is required to reflect the change in outputs.

2.31 The remainder of this chapter sets out how this has changed our proposals from those in our draft reconciliation that we consulted on in October 2016.

### **Thames Water - Lee Tunnel (including Shaft G)**

2.32 The Lee Tunnel is required to reduce the frequency of discharging raw sewage into the River Thames in line with legislation. Thames Water requested that we change the specification of the output to include a new shaft, Shaft G, which would allow integration with the Tideway Tunnel in a way that would have eventual environmental and cost benefits. In a letter dated 8 February 2013, we agreed with this proposal and recognised this would incur additional expenditure in both AMP 5 and AMP 6. We also revised the completion date from 31 March 2015 to 31 December 2015.

2.33 Thames Water delivered the Lee Tunnel (including Shaft G) in January 2016, which was slightly later than the expected date at FD14 of 31 December 2015. We consider that this delay is not significant and as there is no significant change in the date of the delivery of this output no intervention is required. We and Thames Water have considered the financial aspects of the original Lee Tunnel output and Shaft G separately, even though this is one output. At FD14 we logged down £52.7 million of expenditure (£49.1 million post efficiency) related to the original Lee Tunnel and logged up £25.8 million of expenditure (£24.1 million post efficiency) related to Shaft G. Post efficiency figures take account of adjustments for efficiency following our standard process.

2.34 The intervention we proposed in our consultation was to increase the pre efficiency logging down that applied at FD14 for the Lee Tunnel by £8.1 million because less expenditure was incurred than expected. As there is no change in output we should not have proposed an intervention. We have reverted back to the adjustments included at FD14 as set out above.

### **Thames Water - Counters Creek**

2.35 In 2013, Thames Water asked us to agree to log up expenditure for additional outputs which would ultimately help to resolve sewer flooding in an area of London around Counters Creek. The company had been assessing how to

address sewer flooding issues in this area since before 2010 and had found that this would require a major infrastructure project that could not be delivered before 2015. However, it identified a number of outputs that could be delivered by 31 March 2015 as part of a wider solution, which would allow this wider scheme to be delivered as early as possible in the 2015-20 period. In a letter dated 26 July 2013, we agreed a number of integrated outputs and the associated expenditure with Thames to be delivered by 31 March 2015.

2.36 In February 2016, Thames Water reported that it only delivered four of these outputs in whole or in part that amounted to a value of £10.0 million. There were two further outputs that it was supposed to deliver in 2014-15, but expected to deliver similar schemes at some point in 2015-20, amounting to £5.3m. Thames Water proposed in its February submission to log up both the outputs it claimed to have delivered in 2010-15 and those it still planned to deliver in 2015-20. Its reasoning was that it would still incur related expenditure in 2015-20 and no specific account had been taken of this in the 2015-20 wholesale wastewater baseline.

2.37 We consider it is only appropriate to consider delivery of outputs in the 2010-15 period as part of the change protocol adjustment for the 2010-15 period. We have a number of questions regarding the outputs that Thames Water has reported it has delivered related to Counters Creek. We have requested clear evidence from it to substantiate the delivery of these. At this point we do not propose to log up expenditure, pending our review of the evidence from Thames Water that these outputs have been delivered.

2.38 We also note that under the 2010-15 change protocol we only log up or down wastewater expenditure that is financially significant. This is defined as greater than 2% of the company's annual turnover for the wastewater service. If we determine that outputs are required to be logged up, the amounts are likely to be significantly below this threshold. However, related changes associated with a specific change in circumstance can be aggregated. We propose that if any expenditure should be logged up, that we aggregate it with the logging down of other outputs for sewer flooding. The aggregate of the expenditure being logged down is 16.9% of annual wastewater turnover and is far in excess of the required 2% threshold. If expenditure related to further sewer flooding outputs is aggregated, it will remain above the required 2% threshold.

### **Dŵr Cymru – Habitats NEP**

2.39 In the draft reconciliation we proposed to log up actual expenditure of £11.8 million (post efficiency) for outputs related to the Dŵr Cymru's Habitats NEP. We now accept that outputs were delivered as set out at FD14. As there is no change in the outputs, we now consider that we should revert back to the logging up included at FD14. We have therefore included a logging up adjustment of £21.6 million (post efficiency).

### **Southern Water – Testwood**

2.40 At FD09 we included an output to increase the treatment capacity of Southern Water's Testwood water treatment works by 31 March 2015. This is part of an integrated set of actions to increase the water available from sustainable sources and reduce unsustainable abstraction on the River Itchen. This involved working with the Environment Agency and conducting investigations to understand the environmental issues. These continuing investigations have led to a delay in the scheme until March 2018. However, the increased understanding of the environmental issues has allowed a different scope of scheme that has reduced costs by around £20 million from those expected at FD09.

2.41 At FD14 we agreed with the company proposal to change the delivery date of the output. We accepted that some expenditure had been efficiently incurred as part of the scheme, but logged down £53.4 million (post efficiency) to reflect that additional treatment capacity had not been delivered as expected at PR09. The remainder of the scheme will be delivered in the 2015-20 period. In our draft reconciliation we revised the logging down figure to take account of actual expenditure, which was lower than expected. We revised the logging down to £54.6 million (post efficiency).

2.42 As there is no change in the outputs, we still understand the scheme will be completed according to the timescale expected at FD14, we should not make an intervention. We have reverted back to the logging down included at FD14, £53.4 million (post efficiency).

### **Southern Water – Woolston**

2.43 During the 2010-15 period Southern Water identified the most cost beneficial way to meet a nitrogen consent at Woolston wastewater treatment works. The

consent is required to meet the Habitats Directive and the Urban Wastewater Treatment Directive. While this will be completed in the 2015-20 period, Southern Water has incurred expenditure in 2010-15.

- 2.44 At FD14 we logged up £11.0 million (post efficiency). In our draft reconciliation we revised the logging up figure to take account of actual expenditure, which was lower than expected. We revised the logging up to £9.9 million (post efficiency).
- 2.45 As there is no change in the outputs, we still understand the scheme will be completed according to the timescale expected at FD14, we should not make an intervention. We have reverted back to the logging up included at FD14 which was a logging up adjustment of £11.0 million (post efficiency).

#### **Northumbrian Water - Newbiggin and Sedgely**

- 2.46 During the 2010-15 period Northumbrian Water did not deliver two outputs at Newbiggin and Sedgely as these were no longer required, but it did not propose any logging down adjustments at PR14 to reflect this. At FD14 we decided to log down £14.6 million (post efficiency) to reflect the change in outputs. This changed our view of the CIS baseline. We use the CIS baseline to assess if the company's actual expenditure out or under performed.
- 2.47 As explained above in 2.6, how any out or under performance is shared with customers depends on its forecast of expenditure at PR09. This leads to a sharing rate for any out or under performance.
- 2.48 If we agree with the logging up and down proposals of companies, we do not change the sharing rate. This allows for changes in circumstances to be taken into account without changing a company's incentives. However, if companies do not propose appropriate logging up or down then we amend the sharing rate, to provide an incentive for companies to put forward appropriate proposals.
- 2.49 At FD14, Northumbrian Water did not propose a logging down claim for these outputs. As we had a different view to the company, we changed the sharing rate.
- 2.50 In its February 2016 submission Northumbrian revised its submission to propose logging down for these changes in output. We readjusted the sharing rate to reflect this.

2.51 However, we consider we should only make changes if the delivery of outputs has changed, and not whether the company has now accepted that outputs have changed. We have therefore reversed the impact on the sharing rate for these outputs, returning the position back to FD14.

### **Yorkshire Water - Sludge Environmental Permitting Regulations**

2.52 During the 2010-15 period there were changes in the requirements that Yorkshire Water needed to deliver to comply with the Sludge Environmental Permitting Regulations. Yorkshire Water elected to log down £2.7 million (post efficiency) due to the change in the requirements. Even though this change was not financially significant we accepted the companies' proposal because it was in the interests of customers.

2.53 In our draft reconciliation we revised the logging down figure to take account of actual expenditure to deliver the outputs expected at FD14, which was lower than expected. We revised the logging down to £2.8 million (post efficiency).

2.54 As there is no change in the outputs, we consider that we should not make any change to the adjustments made at FD14. We have therefore reverted back to the logging down included at FD14, £2.7 million (post efficiency).

### **Other changes in circumstance**

2.55 We do not consider that any other adjustments in our consultation require revision. In particular we consider the adjustments we made for private sewers remain appropriate. This logging up was not based on particular outputs, but on a relevant change in circumstance from new obligations that arose under the Water Industry (Schemes for Adoption of Private Sewers) Regulations 2011.

2.56 Due to the nature of this new obligation there is no specific output for companies to deliver and we instructed companies to report performance on the transferred sewers separately to its existing network. The activity on the transferred network in 2014-15 has changed from that which was expected at FD14. It is therefore appropriate to revise our view of efficient expenditure for 2014-15 based on this latest information of activity as we did in our draft reconciliation.

## Overall impact of the revised approach

2.57 As explained in the background section above, the revisions we have made above in logging up, logging down and short falling impact the CIS reconciliation. The overall impact of the changes we propose would increase revenue adjustments compared to those we set out in our draft reconciliation. These changes are set out in the table below.

**Table 2: Impact of revisions to change protocol on CIS revenue adjustment (2012-13 prices)**

| Impact on CIS Adjustments (£m 2012-13 prices) | Water Service | Wastewater service |
|---|---------------|--------------------|
| Dŵr Cymru                                     |               | 1.5                |
| Northumbrian                                  |               | 1.4                |
| Southern                                      | 0.1           | 0.2                |
| Thames <sup>1</sup>                           |               | 0.1                |
| Yorkshire                                     |               | 0.03               |

**Note** <sup>1</sup> The impact for Thames Water is subject to any action required for Counters Creek 2010-15 outputs.

### 3. The 2009 agreed overlap programme

- 3.1 This chapter sets out our revised proposals for the reconciliation for 2009 agreed overlap programme (the overlap mechanism). The only companies that this chapter concerns are United Utilities and Thames Water, as these are the only companies for which we made adjustments at FD14. Our revised proposal would have a small financial impact on United Utilities at PR19.
- 3.2 This chapter sets out the background of the overlap mechanism, summarises the responses we had to our consultation on the draft reconciliation and then explains how we have considered these in reaching our revised proposals.

#### Background

- 3.3 We introduced the overlap mechanism at PR09 to allow companies to put forward projects in their business plans that we expected to start in the 2010-15 price control period, but did not expect to finish until the next price control period (2015-20).
- 3.4 This investment mechanism was designed to promote better management of such investment projects and encourage companies to take a long-term approach to planning investment. The mechanism helps companies to avoid the uncertainty arising from the periodic review process when the project was committed and ongoing, and should ensure that the costs to customers are lower overall.
- 3.5 Projects that qualified for this programme needed to have a primary objective of delivering an enhancement in service for customers. They also required measurable outputs, milestones and specified delivery dates. We set out further explanation in section B9 of the [2009 final business plan reporting requirements](#).
- 3.6 In our draft reconciliation we proposed to change the adjustments we made for the overlap mechanism from those we set out at FD14. Further background is set out in chapter 6 of our October 2016 [consultation document](#).

## Consultation responses

- 3.7 We received two responses that had specific comment relevant to the PR09 overlap mechanism.
- 3.8 United Utilities did not propose any revisions. It acknowledged that the approach which we proposed was in line with the expectations set in the PR14 methodology paper that we would not adjust assumptions made at PR14 for the 2015-2020 price control period and set out in the Reconciliation Rulebook that the final reconciliation exercise is confined to updating information for the period 2010-11 to 2014-15.
- 3.9 Thames Water noted in its representations that the draft reconciliation took account of the adjustments for the Lee Tunnel and Counters Creek. However, it did not take account of variations in the level of cost and outputs in the period 2010-2015 for Shaft G and Deephams. In its representations Thames indicated that Ofwat had not treated relevant claims consistently in the draft reconciliation. If the lower expenditure incurred in the 2010-15 period on Counters Creek and the Lee Tunnel than expected at FD14 is taken into account, then to be consistent, the net logging up and down would need to be increased to take account of additional expenditure incurred in the 2010-15 period for Shaft G (£18.3 million) (see chapter 2). Account would also need to be taken of the additional expenditure incurred in the 2010-15 period for the Deephams project as part of the overlap mechanism.

## Further considerations

- 3.10 After reviewing consultation responses, we consider that it was not appropriate to revise the adjustments for the overlap mechanism that we set out at FD14. The rest of the chapter explains why we have reached this view and the impact it has on companies.
- 3.11 The overlap mechanism was introduced for the 2010-15 period. In setting out the details of how we would complete the final reconciliation in April 2014-15 we did not refer to it. In the PR14 [final determination](#) we stated:
- “The overlap programme will be closed as an ongoing mechanism for future control periods. It will not require any future reconciliation in the period 2015-20.”**
- 3.12 The overlap mechanism was explained in the [PR09 methodology](#)

**“We will .... allow each company to set out an ‘overlap’ programme for enhancement projects that start in AMP5 (that is 2010-15) and finish in AMP6. The programme will be available to individual projects with measurable outputs, milestones and specified delivery dates that are part of a phased “evenflow” programme of work – in other words, we would not expect to see a peak of starts at the end of AMP5. We will challenge the projections in the same way as we do for proposals affecting the immediate price review period. Once we have accepted an ‘overlap’ programme we will allow for the capital expenditure required in AMP5 and carry forward the expenditure assumptions for the overlap to the following price review, provided there are no material changes to the required outputs.”**

- 3.13 At FD14 we followed this methodology and set out the adjustments that were required to carry forward expenditure to the following price review for the 2015-20 period by including it in the wholesale wastewater baseline for the 2015-20 period. This is our assessment of the efficient expenditure required for companies to meet their duties and deliver all performance commitments.
- 3.14 In our reconciliation rulebook we stated we would include the overlap mechanism in the final reconciliation for the 2010-15 period as it was an input to the CIS mechanism. In retrospect we should have been clearer over the role the PR09 mechanism would play in the final reconciliation. It was correct to note that the overlap mechanism had a relevance for this final reconciliation, because the resulting adjustments from the change protocol and overlap mechanism are summed and included as integrated inputs into the CIS model. However we should have been clearer that the appropriate adjustments had been decided at FD14. No further adjustments were necessary.
- 3.15 It is important to recognise that adjusting the 2010-15 CIS baseline now would not allow us to carry out our original policy intent. At FD14 we stated we would not revisit the wholesale wastewater baseline for the 2015-20 period. So any adjustment to the 2010-15 CIS baseline as part of this reconciliation will not be reflected in the wholesale wastewater baseline for 2015-20. If we make a change, the envelope of expenditure across the ten years allowed in our baselines could not be the same as set out at FD09. This would not be consistent with the intended policy.
- 3.16 In summary, there is no evidence that the outputs that Thames Water and United Utilities will deliver in the 2015-20 period under the overlap mechanism differ compared to what was expected at FD14. We therefore consider that no change should be made in the final reconciliation for the PR09 overlap mechanism from the financial assumptions set out at FD14.

3.17 We have made no change to our CIS baseline for Thames Water, as the position in our draft reconciliation was the same as we set out at FD14.

3.18 We propose to remove the £8 million intervention we made for United Utilities in the draft reconciliation that we published in October 2016. This would impact the CIS reconciliation and lead to a £1.1 million benefit for United Utilities compared to our draft reconciliation. We will make adjustments for the CIS reconciliation at PR19.

## 4. Next steps

We welcome any comments or representations on our proposals. Please make clear what you consider the impact would be of your representations on other interested parties. Please send written responses by close of business on **31 March 2017**.

You can email your responses to [PR14reconciliation@ofwat.gsi.gov.uk](mailto:PR14reconciliation@ofwat.gsi.gov.uk) or you can submit your responses by post to:

Water 2020  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

We intend to publish all written responses that we receive on our website alongside our final view of the 2015-20 reconciliation.

We cannot always treat the information you provide confidentially. Under the Freedom of Information Act 2000, there is a statutory ‘Code of Practice’ with which public authorities must comply. This deals, among other things, with obligations of confidence.

In light of this, it would be helpful if you could explain 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. We will not consider an automatic confidentiality disclaimer generated by your IT system, in itself, as binding on us.

We may publish or disclose information that you provide, including personal information, in accordance with access to information legislation - primarily the Freedom of Information Act 2000, the Data Protection Act 1988 and the Environment Information Regulations 2004.

At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons that the contents of those written responses remain confidential.