

July 2019

Trust in water

# PR19 draft determinations

**Consultation under section 13 of the Water Industry Act 1991 on proposed modifications to Condition B of the licences of 17 water companies**

## **Consultation under section 13 of the Water Industry Act 1991 on proposed modifications to Condition B of the licences of 17 water companies**

## About this document

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

- Anglian Water Services Limited
- Dwr Cymru Cyfyngedig
- Hafren Dyfrdwy 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
- Portsmouth Water Limited
- South East Water Limited
- South Staffordshire Water plc
- Sutton and East Surrey Water plc

The purpose of the first proposed modification is to enable water companies to levy charges to recover shortfalls in revenue in previous charging years, as long as those shortfalls are calculated in accordance with a formula set out by Ofwat. For the 2020-25 period this will be the Revenue Forecasting Incentive (RFI).

We are also proposing to make a small technical modification to make clear, for the avoidance of doubt, that our 2019 price review (PR19) final determinations can set the opening revenue allowances in the price controls for network plus activities.

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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.

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 is a Notice under section 13 of the WIA91.

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## Responding to this consultation

We invite stakeholders to comment on our proposed modifications by 30 August 2019.

The water companies concerned should also indicate their acceptance or otherwise of the proposed modifications by this date. You can email your responses to [PR19@Ofwat.gsi.gov.uk](mailto:PR19@Ofwat.gsi.gov.uk) or post them to:

PR19  
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Centre City Tower  
7 Hill Street  
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Alex Whitmarsh by email to [alex.whitmarsh@ofwat.gsi.gov.uk](mailto:alex.whitmarsh@ofwat.gsi.gov.uk)

We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk). 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), data protection legislation 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.

## Introduction and background

### Revenue Forecasting Incentive

Water companies are required to set charges in a way best calculated to ensure that their revenues from charges do not exceed the revenues allowed under the revenue controls set by Ofwat. Nevertheless, revenues they earn from charges may still vary from the revenue allowance due to both risks that are controllable by companies, such as forecast accuracy, and other factors that management cannot fully control, such as the impact of weather on demand and optional metering uptake.

In our PR19 final methodology we estimated that, at a sector level, a 2% revenue over-recovery, without correction, would be equivalent to an impact of around 0.9% on the return on regulated equity (RoRE)<sup>2</sup> in companies' favour. Moreover, large systematic over- or under-recoveries may drive end of period movement in customer bills. It may also mean future customers may pay more or benefit at the expense of current customers.

Specifically, for water resources, network plus water and network plus wastewater controls, which effectively limit total revenues, we consider that there is a benefit to allowing companies to 'true-up' for under- or over-recovered revenues during the control period, rather than at the end of the control period, to help smooth any changes in customer bills.

We want companies to take responsibility for accurately forecasting revenues they will collect, to align their interests with those of customers and so provide a small but meaningful financial incentive applied to each year's revenue to achieve this aim.

In our [PR19 final methodology document](#), we said that we would introduce the Revenue Forecasting Incentive (RFI) with in-period adjustments and a financial incentive applied in-period to each year's recovered revenue for the:

- water network plus control;
- wastewater network plus control; and

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<sup>2</sup> The impact on RoRE is calculated as the average of total revenues over five years divided by the average regulated equity. It is based on sector figures that underpinned the 2014 final determinations, it hasn't been adjusted for bioresources, and will vary between companies depending on the relationship between revenue and the regulatory capital value (RCV).

- water resources control<sup>3</sup>.

The RFI will be a new PR19 mechanism. It will replace the Wholesale Forecasting Revenue Incentive Mechanism (WFRIM) which we introduced at the 2014 price review (PR14).

The objective of the RFI is to reduce the impact on customer bills arising from revenue forecasting deviations by:

- incentivising companies to avoid revenue forecasting errors by applying a penalty to variations (either over- or under-recovery) that fall outside the set revenue flexibility threshold in a given charging year; and
- adjusting companies' allowed revenues, so that corrections can be made within the price control period.

In our [PR19 final methodology document](#), we said we would propose a licence modification to make sure that such in-period adjustments are allowed during the 2020-25 period and future price control periods. We said this would be equivalent to the licence modification we made for most companies in 2016 to implement the WFRIM in the current price review period.

## **Opening revenue allowances for network plus activities**

We are also proposing to make a small technical modification to Condition B to make clear, for the avoidance of doubt, that our PR19 final determinations can set the opening revenue allowances in the price controls for network plus activities.

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<sup>3</sup> The RFI will not apply to the bioresources control, which will be subject to volume risk through the average revenue control and a targeted volume forecasting incentive. We do not therefore consider an additional revenue forecasting incentive to be appropriate for bioresources as the control will not limit companies' ability to earn more revenue for greater sludge volumes.

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

### Revenue Forecasting Incentive

We propose amending the licence for companies so that it is clear that water companies can levy charges to recover shortfalls in revenue in previous charging years that are calculated in accordance with the RFI (or an equivalent formula in future price control periods), despite the limits in relation to charges or revenue that we may set in future price controls for wastewater network plus, bioresources, water network plus and water resources activities.

To provide clarity on how the RFI could apply we have also published:

- a draft of the RFI formula in Appendix 3 of the notifications of the draft determination of price controls for each water company; and
- an updated illustrative reconciliation model.

We will notify companies of the final formula when we publish our final determinations of price controls.

The RFI would only apply to the price controls for wastewater network plus, water network plus and water resources activities in the 2020-25 period. We do not consider an additional revenue forecasting incentive to be appropriate for bioresources as:

- this control is an average revenue control and so does not require companies to accurately forecast volumes to a revenue limit; and
- we provide a separate incentive mechanism for forecasting accurate volumes.

The change 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 2020-25 period. Companies may experience a small, but meaningful penalty if there is a significant imbalance between the relevant allowed and actual revenues.

Ofwat would need to notify the formula for each price control period (and the charging years in which shortfalls could be recovered) to each water company by no later than 31 December in the price review year (i.e. by 31 December 2019 for PR19). The proposed modification would not apply if Ofwat did not notify a formula to a water company.

Where the price controls that Ofwat has determined at a price review are referred to the Competition and Markets Authority (CMA), the CMA will be able to make changes to any formula that Ofwat had notified to the water company for that price control period.

An illustrative example of the wording of the proposed modification to Condition B (Charges) to be inserted after sub-paragraph 9.1 for water and sewerage companies (other than Hafren Dyfrdwy Cyfyngedig) or sub-paragraph 8.1 for water only companies and Hafren Dyfrdwy Cyfyngedig, is set out below:

8/9.1A Sub-paragraph [8/9.1] does not prevent the Appointee from levying charges to recover a Relevant Shortfall in a Relevant Charging Year, regardless of the controls set in the Price Controls determined under sub-paragraph [8/9.4]. For the purposes of this sub-paragraph:

- (a) “a Relevant Charging Year” means any charging year, and
- (b) “a Relevant Shortfall” means any positive amount calculated for a Relevant Charging Year in relation to one or more specified Price Controls in accordance with any formula

that in both cases the Water Services Regulation Authority has notified to the Appointee by no later than 31 December in the Charging Year before the immediately preceding Review Charging Year.

8/9.1B Where a notification of a formula is made for the purposes of sub-paragraph [8/9.1A], that notification shall be treated for the purposes of sub-paragraph [15/16.1] (regarding references to the Competition and Markets Authority) as part of the relevant determination made under sub-paragraph [8/9.4].

In relation to the above wording, please note that:

- the term "Review Charging Year" is defined in Condition A (Interpretation and Construction) as “the first of the Charging Years in respect of which any Periodic Review is carried out”; and
- the lower alternative paragraph numbers (8 and 15) relate to Condition B in the licences of water companies that only hold an appointment as a water undertaker and Hafren Dyfrdwy Cyfyngedig and the higher paragraph numbers (9 and 16) relate to Condition B in the licences of other water companies.

## Opening revenue allowances for network plus activities

At PR19 Ofwat will, for the first time, set separate price controls for activities that are currently covered by price controls for wholesale water and, for water and sewerage companies, wastewater activities. Wholesale water activities will be covered by separate price controls for network plus water activities and water resources activities. Wholesale wastewater activities will be covered by separate price controls for network plus wastewater activities and bioresources activities.

The network plus controls must, in accordance with Condition B (Charges), be in the same form as the existing controls for wholesale activities. That means inflation plus or minus  $K^4$  controls that limit the percentage change in the charges to be levied by and/or revenue allowed to the regulated business in each charging year in respect of the activities concerned. In accordance with our PR19 methodology we will set controls that limit changes in the revenue allowed to the regulated business in respect of the activities concerned.

We propose to amend the licences of the relevant water companies to make clear, for the avoidance of doubt, that when setting the first network plus price controls at PR19 Ofwat can set the opening revenue allowances for network plus water and wastewater activities (as well as limits on the change in the revenue allowed to the regulated business in each charging year in respect of those activities).

We propose to make the modification by inserting a new sub-paragraph at the end of Part VIII of Condition B (which already contains other transitional provisions relating to the introduction of new price controls) along the following lines:

19/20.3 In relation to the determination of a Price Control in respect of the Appointed Business's Network Plus Water Activities [and a Price Control in respect of the Appointed Business's Network Plus Wastewater Activities] for the period starting on 1 April 2020, sub-paragraph [8/9.4(2)(a)] of this Condition B shall, for the avoidance of doubt, have effect as if it allowed the determination of a Price Control that includes an amount in relation to the Charging Year starting on 1 April 2020 that has effect as if it was the revenue allowed to the Appointed Business in respect of the activities concerned for the Charging Year starting on 1 April 2019.

In relation to the above wording, please note that:

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<sup>4</sup> "K" is a number and may be a positive number, a negative number or zero.

- the text in square brackets in relation to “Network Plus Wastewater Activities” is only relevant to water companies that hold appointments as both a water undertaker and a sewerage undertaker; and
- the lower alternative paragraph numbers (8 and 19) relate to Condition B in the licences of water companies that only hold an appointment as a water undertaker and Hafren Dyfrdwy Cyfyngedig and the higher paragraph numbers (9 and 20) relate to Condition B in the licences of other water companies.

## Why do we need to make our proposed changes?

### Revenue Forecasting Incentive

In the [rulebook published in July 2015](#), we explained that we had identified an issue regarding the consistency between the original wholesale revenue forecasting incentive mechanism (WRFIM) formula for the 2015/16 to 2019/20 period and companies' licences. In summary, the licence allowed price controls to limit the annual change in allowed revenue and 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 meant the company was 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 did 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](#), we summarised the range of views expressed and our decision that we would allow each company to choose their preferred solution. In October 2016 we undertook the [statutory consultation](#) in order to bring about this change and subsequently provided [notification](#) of this change.

This WFRIM licence change was deliberately targeted to facilitate the WFRIM. Although the licence issues we identified in 2015 are also relevant to the RFI, we need to introduce the proposed licence change because the 2016 licence change was specific to the WFRIM formula and the WRFIM licence change only has effect until 31 March 2020.

We continue to consider that it is appropriate to allow companies to 'true-up' for under- or over-recovered revenues during price control periods, rather than at the end of the review period, to help smooth changes in customer bills.

To reduce the need for future licence changes, we do not place a time limit on the proposed licence change for the RFI. This reflects our planned approach as set out in our PR19 final methodology.

### **Opening revenue allowances for network plus activities**

We need to set the opening revenue allowances for network plus water and wastewater activities at PR19 because this is the first time we will be setting price controls for network plus activities. There are no existing network plus revenue allowances for 2019-20 (the last year of the current price control period) in relation to which we could set a limit on the change in the revenue allowed to the regulated business in respect of those activities for 2020-21 (the first year of the new price control period).

Condition B currently says that the network plus controls must be set in the form of inflation plus or minus K controls that limit the percentage change in the charges to be levied by and/or revenue allowed to the regulated business in each charging year in respect of the activities concerned. It does not currently explicitly say that Ofwat can set the opening revenue allowances. We propose to make this modification to make clear, for the avoidance of any possible doubt, that Ofwat has the power to set the opening revenue allowances when setting the first network plus price controls at PR19.

At PR19 we will also set the opening revenue allowances for water resources activities (we will not do so for bioresources activities because we are proposing to set a different form of control). We are not proposing any modification for water resources activities (or bioresources activities) because Condition B is less prescriptive about the form of the water resources (and bioresources) controls than about the form of the network plus controls.

## 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 **30 August 2019**.

Subject to the responses to this consultation of the agreement of the companies concerned, we expect to amend companies' licenses before the end of 2019.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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