

December 2019

PR19 final determinations

**Portsmouth Water – Accounting for past
delivery additional information**

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PR19 final determinations: Portsmouth Water - Accounting for past delivery additional information

Wholesale revenue forecasting incentive mechanism additional revenue

1 Our draft determinations

In our draft determination we proposed to exclude Portsmouth Water's claim for additional revenue in the wholesale revenue forecasting incentive mechanism (WRFIM). The claim relates to errors Portsmouth Water made in completing its business plan tables for connection charges at PR14, and we consider this to be outside of the reconciliation mechanism's scope.

Our intervention for the draft determination reduced the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from £0 million in the company's business plan to - £2.682 million (2017-18 FYA CPIH deflated price base).

2 Stakeholder representations

In its representation on our draft determination, Portsmouth Water strongly disagrees with the intervention we proposed in the draft determination on the grounds that it considers it reverses a previously agreed position on correcting the error in its PR14 business plan through the wholesale forecasting incentive mechanism reconciliation.

The company argues that at PR14 it did not classify connection charges as "Grants and Contributions" (although connection charges were included in the PR14 business plan). The company argues that as a result, the PR14 final determination excluded this income from the overall wholesale price control. Following a query, the company states it reflected connection charges income under rechargeable works (which are a third party service) and included the costs of new connections in total wholesale operating expenditure, not capital expenditure. Portsmouth Water states that this means that over the 2015-20 period grants and contributions were under forecast by £3.4 million (2012-13 prices) and that third party income was over forecast by £3.4 million (2012-13 prices).

Portsmouth Water states it realised this was an error when completing its annual performance report (APR), as table 2I (Revenue analysis and wholesale control reconciliation) explicitly requires connection charges to be included in "Grants and Contributions". It notes having reported this issue to Ofwat and argues it was agreed that the company should report connection charges as per the regulatory accounting guidelines (RAG) in table 2E but exclude it from the reconciliation of wholesale income in table 2I. The company acknowledges it has no written confirmation of what had been agreed.

Notwithstanding what Portsmouth Water argues to be the reversal of a previously agreed position with Ofwat, the company disagrees with the proposed wholesale revenue forecasting incentive mechanism adjustment because it is not a result of inaccurate forecasting but of not comparing “like for like”. To address this, the company proposes to strip connection charges income received out of revenue recovered or, alternatively, an adjustment to be made to the allowed revenue to include the connection charges so that a like for like comparison is being made.

We received no other representations in relation to the intervention on Portsmouth Water’s wholesale revenue forecasting incentive mechanism.

3 Our assessment and reasons

The wholesale revenue forecasting incentive mechanism allows for representations from companies regarding the application of the revenue adjustment, namely when demand for connections is unexpectedly high (subject to companies demonstrating the reasons for the variance were unexpected and beyond the company control). Our principles for assessing claims for additional revenue under the wholesale revenue forecasting incentive mechanism are set out on pages 42 to 44 of the ‘[PR14 reconciliation rulebook](#)’.

Having reviewed the information and actively considered all issues raised in the representation provided to us, we maintain our view that the company’s claim is outside the scope of the wholesale revenue forecasting incentive mechanism. This is because Portsmouth Water argues it made an error in not classifying connection charges as grants and contributions in its PR14 business plan, which is outside of the scope of the mechanism to correct. It is not trying to justify a demand variation, which is what the claims process in the mechanism is intended to manage.

Given that the company argues it made a reporting error, we should note that the reconciliation process is not an opportunity to reopen PR14 final determinations, as a way to revisit the exercise of regulatory judgments. In order to provide confidence in the accuracy and legitimacy of regulatory process we apply a high bar for error correction and therefore we only correct unambiguous errors, consistent with our approach to error correction in reconciliations as applied in ‘[Updated 2010-2015 reconciliation](#)’.

We consider that the company does not provide sufficient evidence that it has made an unambiguous error, nor that the impact of that error – and therefore the proposed correction – are unambiguous.

We consider our revised business plan definitions at PR14 were clear and that the company should have included connections charges in either of lines 2 & 14 in table W9 and not line 4 as Portsmouth Water states to have done (see table 3.1).

Table 3.1: PR14 data table W9 – Portsmouth Water’s revised business plan

W9 - Wholesale revenue projections for water service

Line description	Item reference	Units	DPs	Price base	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	
A Revenues - wholesale water											
1	Wholesale control (excluding connection & infrastructure charges)	W9001	£m	3	2012-13	30.292	29.959	30.007	30.061	30.162	30.262
2	Connection & infrastructure charges (including requisitions and self-lay) treated as revenue in statutory accounts	W9002	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
3	Total revenue - wholesale water control	W9014	£m	3	2012-13	30.292	29.959	30.007	30.061	30.162	30.262
B Third party income											
4	Rechargeable works	W9004	£m	3	2012-13	1.496	1.281	1.281	1.281	1.281	1.281
5	Bulk supplies - contract not qualifying for water trading incentives (or signed before 1 April 2015)	W9005	£m	3	2012-13	0.176	0.000	0.000	0.000	0.000	0.000
6	Bulk supplies - contract qualifying for water trading incentives (to be signed on or after 1 April 2015)	W9006	£m	3	2012-13		0.000	0.000	0.000	0.000	0.000
7	Other appointed business	W9007	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
8	Third party services	W9008	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
9	Total third party income	W9015	£m	3	2012-13	1.672	1.281	1.281	1.281	1.281	1.281
10	Revenue grants	W9003	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
11	Other sources	W9009	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
C Other operating income											
12	Other operating income	W9011	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
D Other income											
13	Other income	W9012	£m	3	2012-13	0.000	0.000	0.000	0.000	0.000	0.000
E Capital contributions from connection and infrastructure charges											
14	Connection and infrastructure charges (including requisitions and self-lay) treated as a capital contribution in statutory accounts	W9013	£m	3	2012-13	0.923	0.907	0.901	1.052	1.247	1.226

Based on our assessment below, we conclude that this error does not fit the criteria of an unambiguous error. The error is not unambiguous and direct to detect. It is also not clear and unambiguous how we would correct for the error if there had indeed been one.

To identify whether the error is unambiguous, we assess if there is evidence that Portsmouth Water made the error in the way it alleges. In particular we compare Portsmouth Water's forecasts of third party income and connections charges to outturn figures. In both cases this is not clear and unambiguous that Portsmouth Water made the error in the way it alleges.

For third party income we compare Portsmouth Water's PR14 business plan forecasts (third party income) with outturn non-price control revenue, which measures similar income lines¹. If, as Portsmouth Water alleges, it had included connection charges in third party income, the outturn non-price control revenue would be around £3.4 million lower than the PR14 business plan forecast over the 2015-20 period (2012-13 prices).

Overall, while the difference varies across years, the net difference over 2015-19 is less than half of what would be expected. We would not expect these figures to match precisely as there will always be some real world effects that are not taken into account when forecasting, and the two compared lines are not defined in exactly the same way. This comparison does not unambiguously demonstrate that the PR14 business plan forecasts for third party income were overstated.

Table 3.2: Third party income PR14 forecasts and actuals (£ million, nominal prices)

	2015-16	2016-17	2017-18	2018-19	Total 2015-19
Third party income PR14 business plan forecasts	1.367	1.410	1.457	1.492	5.726
Non price control revenue received	2.151	1.035	0.388	0.607	4.181
Difference	0.784	-0.375	-1.069	-0.885	-1.545

Source: non price control income in table 2A, line 2 from annual performance report and PR14 final determination (table W9, line 9).

For grants and contributions we accept that there is a difference between outturn and forecast income across years that in aggregate is consistent with Portsmouth Water's argument. However this varies year by year and does not unambiguously

¹ Non-price control revenue as reported in the annual performance report includes third party services and management of protected land. Third party income in PR14 final determination included third party income.

demonstrate that Portsmouth Water made an error of the scale identified, rather than incorrectly forecasting grants and contributions revenue.

Table 3.3: Grants and contributions PR14 forecasts and actuals (£ million, nominal prices)

Variance analysis of grants and contributions	2015-16	2016-17	2017-18	2018-19	Total 2015-19
Capital contributions from connection charges and revenue from infrastructure charges (PR14 final determination)	0.968	0.992	1.196	1.453	4.609
Grants and contributions received	2.054	1.767	1.635	2.520	7.976
Difference	1.086	0.775	0.439	1.067	3.367

Source: annual performance report and PR14 determination.

On the basis of the information provided we are unable to determine whether the adjustment Portsmouth Water requests reflects the level of connection charges forecast at PR14.

In the claim the company provides a forecast of what it states it understated connection charges by in PR14. The data the company provided at PR14 is not sufficiently disaggregated to allow us to verify the amount of connection charges the company refers to in its claim. The analysis we present in the tables above is not sufficient in itself, in the absence of disaggregated data to support the company's claim in view of the need to demonstrate that there is an unambiguous error.

We note that an objective of the PR14 incentive mechanism was to strengthen incentives on companies to forecast expected activity correctly. The company does not provide sufficient evidence that any under forecast of connection charges is due to an error rather than simply inaccurate forecasts. To ensure a level playing field with other companies, we can only use forecasts, and therefore errors, that can be proven with data made available at the time of the submission of PR14 business plans. This is not the case here.

Portsmouth Water suggests that we could exclude connection charges from the revenue collected in the wholesale revenue forecasting incentive mechanism reconciliation. We do not consider that this is appropriate. While we could exclude connection charges from the outturn forecasts, it is not clear on what basis we would make an adjustment to the base revenue allowance as it is not clear to us that Portsmouth Water included a zero forecast for connection charges in its PR14 business plan. In addition, even if we could make an appropriate adjustment, this would put Portsmouth Water in a different position to other companies as it would not be taking any risk over the forecasting of connection charges. One of the main objectives of wholesale revenue forecasting incentive mechanism was to provide

incentives to improve accuracy of revenue forecasting. We therefore do not consider that we should make this adjustment.

We acknowledge the company reported the issue in 2016. At the time we only agreed the company could report on a particular basis in its annual performance report. Portsmouth Water does not present any evidence that we agreed with its view to adjust the wholesale revenue forecasting incentive mechanism reconciliation. If any such agreement were to have taken place, this would have required full decision making and appropriate consultation, and there would have been documentary evidence to any such agreement.

Finally the company proposes to adjust its recovered revenue in the wholesale revenue forecasting incentive mechanism model because of its reporting error. However the company takes no account of the potential impact any such error could have had on allowed totex at PR14:

- In PR14 we calculated allowed totex for new developments based on industry historical unit rates per connection and a common assumption about the percentage that should be funded by customers. Therefore the company's omission of capital expenditure relating to new connections in its business plan would have had no impact on the totex allowance it received for new developments.
- However, as a result of including connection charges income under rechargeable works, the company would have received more totex for third party services at PR14 than it would have otherwise received. This is because we allowed in totex 46% of third party income using the company's business plan view to reflect our view of third party costs. (Historically the company's third party costs represented 46% of its third party income.)

This means that any error on the allowed revenue will have been partially offset by a higher totex allowance. Therefore we do not agree with the company's assessment of the potential impact of the error, if indeed there was one.

4 Our final decision

We are not amending the revenue in the wholesale revenue forecasting incentive mechanism to correct the error in Portsmouth Water's PR14 business plan forecasts.

Our intervention for the final determination increases the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from - £0.489 million in the company's 15 July 2019 submission to - £4.442 million (2017-18 FYA CPIH deflated price base).

Our intervention is larger for the final determinations than for the draft determinations as the outturn data for grants and contributions, which we use for the final determinations, includes connection charges. We used the company's latest available forecasts for 2018-19 for the draft determinations, which did not include connection charges.

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December 2019

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