December 2019

# PR19 final determinations

## South Staffs Water – Accounting for past delivery additional information

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# Wholesale revenue forecasting incentive mechanism additional revenue

## 1 Our draft determinations

In our draft determination we proposed to exclude some elements of South Staffs Water's claim for additional revenue in the wholesale revenue forecasting incentive mechanism (WRFIM).

South Staffs Water's claim is for an additional £18.882 million (nominal prices) of grants and contributions revenue to be recovered in wholesale revenues than included in the 2014 final determination. The drivers of the claim are:

1. unexpectedly high demand for connections during the 2015-20 period;
2. less self-lay connections than forecast by the company;
3. more complex and costly connections than forecast; and
4. errors the company made in completing its business plan tables for mains requisition charges at PR14.

The company had explained and evidenced the approach taken to develop its PR14 forecasts and demonstrated that the increase in connection volumes was due to brownfield development that was unexpected and is harder to forecast. We therefore included the elements of the claim that are driven by the volume of new connections in the draft determination. But we excluded those elements where the variance has been driven by the cost or type of new connection, as we considered they are not within the scope of the adjustment as set out at PR14, which related to the demand for new connections only.

We also considered that claims due to errors companies made completing business plans at PR14 are outside the scope of the adjustment mechanism. We therefore excluded the element relating to the error on mains requisition charges.

We intervened to reduce the aggregate value of the revenue claim reflected in the wholesale revenue forecasting incentive mechanism from £18.882 million to £6.004m (nominal prices).

Our intervention for the draft determination increased the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from -£1.883 million in the company's business plan to - £16.891 million (2017-18 FYA CPIH deflated price base).

# 2 Stakeholder representations

In its representation on our draft determination, South Staffs Water asserts that all the elements of the claim related to unexpectedly high demand for connections and main requisition charges should be reflected in the wholesale revenue forecasting incentive mechanism. The company reproduces its revised business plan response to the actions we set in the initial assessment of plans. The updated information from the 15 July 2019 submission reduces the revenue claim by £0.790 million to £18.092 million, as a result of updating the 2019-20 forecasts of grants and contributions to reflect the new four-year average connection cost data available.

The company's evidence provides an explanation of its approach to developing its PR14 forecasts and suggests that the variance in the cost of connections is related to the volume of connections. To calculate an average cost per connection at PR14, it states that it had to estimate the volumes of standard and more complex connections individually. As the company forecast a much lower volume of more complex connections, this resulted in a lower average connection charge, which was then used to calculate its forecast revenue from connection charges.

The company continues to argue that the definition of capital contributions from connection and infrastructure charges only included a reference to requisitions when the final set of updated tables were issued in June 2014. It also argues the wording is ambiguous and that it interpreted this line as being all connection charges and infrastructure charges for both requisitions by the company and for self-lay as the words are in brackets.

South Staffs notes that it has engaged with us on the issue of developer services contributions since July 2016. The company argues that it has been open and transparent on this issue and states that "At no point during the period has Ofwat ever stipulated that we would be likely to face such a material penalty".

Following further engagement with the company, it confirmed that its representation on our draft determination reduced the total value of the claim set out in its 15 July 2019 submission by £1.436 million to £16.656 million. This is made up of a downward revision of £0.319 million to the unit cost element of the claim and a downward revision of £1.117 million relating to a purported error for mains requisition charges, recognising that this revenue is outside of the reconciliation mechanism, although the company maintained that it does not consider that it is fully at fault.

We received no other representations in relation to the intervention on South Staffs 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's 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 acknowledge it is appropriate to include the element of the claim related to the cost of the connections within the wholesale revenue forecasting incentive mechanism reconciliation.

For the draft determination we considered that the brownfield development was unexpected and is harder to forecast. Based on the analysis of the representation we now acknowledge that the average unit cost calculated for the PR14 forecast will not have taken account of the higher costs associated with these types of connections. This is because these more expensive connections have made up a greater proportion of new connections than anticipated, thus increasing the average connection cost. We therefore agree with the company that the element of the claim related to the cost of new connections will also have been driven by the volume of new connections.

As South Staffs Water has made clear and well evidenced representations that the variance related to cost is also driven by volume we are additionally including the element for the additional cost of connections in the final determination.

We continue to exclude the variance driven by connections delivered through the self-lay route. We maintain our view that this is outside of the scope of the adjustment as set out at PR14 which related to the demand for new connections only. The proportion of self-lay connections is not directly related to the volume of connections. The number of self-lay connections could have been better forecast by the company at PR14; the company explained to us verbally in a meeting on 1 December 2017 that it made an assumption that the higher level of self-lay activity in its Cambridgeshire region would be replicated in South Staffordshire, but did not present an evidenced explanation why it thought that this was a reasonable basis for its forecasts. We also consider that the level of self-lay activity in the company's area is not completely outside of management control, but the company did not present a credible plan for how it would facilitate the increase in self-lay activity that it forecast.

In relation to South Staffs Water's claim that it made an error in its PR14 business plan in relation to requisitions, the reconciliation process is not an opportunity to reopen PR14 final determinations, as a way to revisit the exercise of regulatory judgments. 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'.

Our assessment of this error shows it does not fit the criteria of an unambiguous error. We consider that the PR14 business plan guidance was clear about the classification of requisitions. The error is not unambiguous and direct to detect. The company provides no evidence that would allow us to confirm that the value reported at the time did not include the forecast of mains requisition charges. We therefore do not think it would be in customers' interests to include additional revenue in the wholesale revenue forecasting incentive mechanism in respect of the error.

We consider our revised business plan definitions at PR14 were made clear with sufficient time for these to be taking into account ahead of business plan submission. We do not consider that the wording is ambiguous for the capital contributions line, as all but two companies completed the table as intended.

South Staffs Water proposes that the adjustment could be made as a midnight adjustment[1] to the regulatory capital value (RCV) reflective of that fact that this is as a result of capital income. In line with our stated methodology for the wholesale revenue forecasting incentive mechanism, we are applying the adjustment arising from the mechanism as a revenue adjustment.

We acknowledge that the company has engaged with us on the issue of developer services contributions. We note that we did not provide any indication on how this would be included, if at all, in the wholesale revenue forecasting incentive mechanism reconciliation as this would have required full decision making and appropriate consultation.

# 4 Our final decision

We are including more of the claim for additional revenue in the wholesale revenue forecasting incentive mechanism that arises from unexpectedly high demand for connections. We are now including the elements of the claim related to the volume of connections and the cost of connections. However we are not amending the revenue in the wholesale revenue forecasting incentive mechanism to correct the error in South Staffs Water's PR14 business plan.

[1] Midnight adjustments to the regulatory capital value occur at midnight as one five year asset management period ends on the 31 March and the next starts on the 1 April, in this case in 2020.

We are reducing the aggregate value of additional revenue reflected in the wholesale revenue forecasting incentive mechanism from £16.656 million in the company's 30 August 2019 representation to £12.267 million (nominal prices).

Our intervention for the final determination reduces the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from - £2.057 million in the company's 15 July 2019 submission to - £9.154 million (2017-18 FYA CPIH deflated price base).

**Table 4.1: Claim for additional revenue and the wholesale revenue forecasting incentive mechanism adjustment**

| | April 2019 revised business plan | Draft determination | 15 July 2019 past delivery submission | 30 August 2019 representation | Final determination |
|---|---|---|---|---|---|
| Additional revenue claim (£ million, nominal prices) | | | | | |
| Volume of new connections | 6.004 | 6.004 | 6.406 | 6.406 | 6.406 |
| Cost of new connections | 7.436 | N/A | 6.179 | 5.860 | 5.860 |
| Self-lay route | 2.329 | N/A | 2.397 | 2.397 | N/A |
| Error completing PR14 business plan | 3.113 | N/A | 3.109 | 1.992 | N/A |
| Total | 18.882 | 6.004 | 18.091 | 16.656 | 12.267 |
| wholesale revenue forecasting incentive mechanism adjustment (£ million, 2017-18 FYA CPIH deflated price base) | | | | | |
| Wholesale revenue forecasting incentive mechanism adjustment | -1.883 | -16.891 | -2.057 | Not stated | -9.154 |

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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