

Information notice

IN 20/06 July 2020

ofwat

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

Approach to PR19 Blind year adjustments for 2019-20 performance

This information notice sets out the way in which we expect the largest water companies in England and Wales to update their reconciliation of the 2015-20 incentive mechanisms to reflect their actual performance in 2019-20.

Background

This information notice provides further detail of the blind year adjustment process. The blind year adjustment process will confirm the revenue and RCV adjustments to account for differences between the forecast performance for 2019-20, included in our PR19 final determination, and the actual performance reported for 2019-20.

- IN 20/04 '[Expectations for PR19 blind year reconciliation of PR14 incentive mechanisms](#)' (April 2020) set out reporting guidance and expectations for the overall blind year submission process and the specific blind year in-period determination for ODIs.
- '[PR19 Reconciliation Rulebook Consultation – proposed approach and policy](#)' explained how revenue and RCV blind year adjustments would be applied, that is whether they would be recovered during 2020-25 ('in period') or as part of the 2024 price review process ('end of period').

The PR19 Reconciliation Rulebook consultation also set out the possibility of two changes relevant to the blind year adjustment process that a licence modification could implement. These would, if made, allow totex menu revenue blind year adjustments to be applied in period and unambiguous revenue errors to be corrected as part of the blind year adjustment. This information notice also confirms how we intend to take these two issues forward in light of responses to the PR19 Reconciliation Rulebook consultation.

Making blind year revenue and RCV adjustments

The PR19 Reconciliation rulebook consultation explained that revenue and RCV adjustments would be applied in three different ways.

- **wholesale revenue adjustments** will be applied over one or more of the last four years of the 2020-25 period through the revenue forecasting incentive (RFI) – this includes blind year adjustments related to the PR14 wholesale revenue forecasting incentive (WRFIM), water trading incentives, and the Totex menu – and changes to price controls for the PR14 outcome delivery incentives;
- **retail revenue adjustments** will be applied as end-of-period revenue adjustments through the PR19 residential retail reconciliation model – this includes blind year adjustments related to the PR14 residential retail reconciliation model; and
- **RCV adjustments** from the totex menu, PR14 outcome delivery incentives and land sales will be applied at PR24 – because these adjust the RCV.

For the avoidance of doubt we confirm that adjustments will be applied in this way as no significant issues were raised in the responses to the consultation.

We will set out our view on the responses we have received in the responses document which we will publish alongside the final PR19 reconciliation rulebook in the autumn.

Expectations in relation to the in period ODI process

We explained in IN 20/04 that the PR19 final determinations designated all PR14 performance commitments as in-period for the purposes of the blind year adjustment for 2019-20. This means the provisions of Condition B Part 3A (Performance Measure Adjustments) apply. These provisions, amongst other things, allow for Ofwat or companies to initiate an in period ODI determination. They require companies to formally request a determination by 15 August if they wish to proceed. They also allow for part of the calculated adjustment to be spread across one or more charging years in the price control period, if appropriate.

For the avoidance of doubt, we intend to undertake an in period determination in 2020 as part of our wider blind year adjustment process for all companies. Consequently, companies do not need to request a determination. We also do not expect companies to submit proposals on spreading ODI adjustments across charging years. This is because we expect ODI adjustments to be relatively small (as we are only adjusting for the variance from forecast performance) and because the blind year revenue adjustments that are applied through the RFI formula provides some flexibility to companies to manage volatility.

If a company chooses to submit a proposal to spread the blind year ODI adjustment across two or more years we would expect it to set out in full its reasons and it should demonstrate how it has taken the views of stakeholders into account in reaching its view.

Licence modifications relevant to the blind year adjustment process

The PR19 Reconciliation rulebook set out the possibility of two possible changes relevant to the blind year adjustment process that a licence modification could implement. The first was to allow for any revenue associated with the blind year reconciliation of totex menus to be applied in period by including it in the blind year adjustment figure for the RFI formula. This was not included in our notifications of the RFI formula that accompanied the price control determinations but, as part of our work on the consultation, we identified the need to also include any applicable blind year revenue adjustment arising from the totex menu model. The intention is to apply all revenue-based blind year adjustments to wholesale price controls for the last four years of the price control period. **We confirm that we will take forward a proposed licence modification that includes this change.**

We received 11 responses from companies on this proposal and eight of these supported the proposal. No company which responded on this issue favoured the 'do nothing' option.

We also consider that this option is the most straightforward way of meeting the aim of applying all revenue-based blind year adjustments to wholesale price controls over the last four years of the price control period. This ensures that the impacts on revenue are felt by companies closer to the performance to which they relate. In developing the proposed modification we will work with companies to understand, and address if possible, any concerns with the form of the modification which we are proposing and any impact the change may have. We will set out our view on the responses we have received in the responses document which we will publish alongside the final PR19 reconciliation rulebook in the autumn.

The second potential change identified would allow unambiguous revenue errors in relation to our final determinations to also be included in the blind year adjustment figure for the RFI formula. **We confirm that the proposed licence modification we are taking forward will include this change.**

We received consultation responses from ten companies and CCWater. The majority of respondents, other than two water companies, supported such a change. **We provide further detail on this modification in annex 1.**

We will be contacting companies separately on these proposed modifications. We will work to make the changes ahead of our final determination on blind year adjustments in mid-November. If, ultimately, the proposed licence modifications are not made, this would mean that:

- Blind year revenue adjustments for totex menus will be applied as part of PR24.
- We would not correct for any unambiguous revenue errors until PR24.

Timetable and next steps

It is our intention to finalise all details of the blind year adjustments by 15 November 2020. This is the date by which Part 3A of Condition B requires in period ODI determinations to be made. Although there is no requirement for the other elements of the blind year adjustments to be finalised by this date, it is our preference to do so to the same timetable.

We expect to run a short query process, following the companies' submission of information on 15 July. We intend to run a short consultation on our proposed blind year adjustments towards the end of September.

The relatively short timescale for this process places greater emphasis on companies ensuring that submissions are clear and well evidenced and supported by appropriate assurance. This will be particularly important if companies expect to report materially different performance to the forecasts included in the PR19 final determination.

If you have any questions about this information notice please email PR19BlindYear@ofwat.gov.uk.

Annex 1 – further information on unambiguous revenue errors and the proposed licence modification

We recognise the importance of correcting any errors as soon as practical. Where an unambiguous revenue error is identified shortly after our final determinations and it is pragmatic to do so, it would be right to correct it as part of the blind year reconciliation if possible rather than wait until PR24.

As part of consultation on our reconciliation rulebook, we asked whether, if the scope of the blind year adjustment term in the RFI formula was amended to include the revenue blind year adjustment arising from the totex menu model, that amendment should be extended to include an adjustment for any unambiguous revenue errors in relation to our final determinations of price controls. We received responses from ten water companies and CCWater. All respondents, other than two water companies, supported the proposal.

Although some objections were raised we think, based on the majority of responses received that we should proceed to more detailed drafting and discussion on these changes with companies. Our intention would be to make licence modifications if companies agree. In light of our objectives (set out above) and the issues raised by stakeholders in response to our consultation, we are setting out the following clarification and guidance about what this would cover and how we intend to go about this.

The licence modification process. We intend to contact companies soon with an outline of the licence modifications. This will allow stakeholders to understand how we propose to exercise the licence change before formally agreeing to it.

Subject to companies' views, we propose to publish a formal section 13 consultation in the second half of September (to align with our blind year adjustment consultation).

If companies agree to the proposed licence modifications, we would implement changes in time to correct for any unambiguous revenue errors (where appropriate) as part of our final blind year adjustment decisions in November.

Scope of the licence modification. In the reconciliation rulebook, we explained that the modification would cover unambiguous revenue errors. Taking account of the responses we received, we set out below the scope of the process. We intend it to be limited to potential errors that:

- i) are notified to us as soon as possible. As set out in the reconciliation rulebook consultation document we expect any potential errors to be submitted alongside the annual performance reports this year at the latest. This is because we intend to set the blind year adjustment figure for the RFI formula this autumn and will need time to consider any claims. Companies should notify us of any such errors whether or not they are in the company's favour.

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- ii) are unambiguous (consistent with our wider approach to errors where we apply a high bar for error correction) and that we made in companies' final determinations.
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- iii) relate to revenue only. Adjustments to the RCV must be made at price reviews.

We have decided not to implement a materiality threshold. However, given the tight timescale for this work, we expect that stakeholders will focus on urgent revenue errors that cannot wait until PR24 to be rectified.

Appeal process. We considered whether there should be a separate appeals process for this mechanism but concluded that it is not necessary because this is a one off time limited process and further opportunities for raising potential errors exist.

Definition of an 'unambiguous error'. Given the importance of regulatory certainty for both companies and customers, there is a high bar for making adjustments. We would normally only expect to consider the possibility of an adjustment in the event of unambiguous errors.

We will judge each case on its merits. That said, we recognise that some guidance is helpful to stakeholders. In general, to be considered an 'unambiguous error' it must be:

- unambiguous that an error was made;
- unambiguous in terms of the impact of the error;
- direct to detect;
- straightforward to correct; and
- be able to be reasonably detected by a diligent company.

Therefore, it will exclude errors that require significant analysis or judgement in order to determine if they are truly an error or their magnitude. Furthermore, the process is not a chance to revisit regulatory judgements and therefore it will exclude any issue we were aware of before we made our final determinations.

More information

[IN 20/03: Expectations for monopoly company annual performance reporting 2019-20, April 2020](#)

[Data table template for the PR19 blind year submission, Excel template](#)

[PR19 blind year ODI performance model](#)

[Non-standardised ODI calculation pro forma](#)

[PR19 blind year ODI difference model](#)

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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