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Adjusting for company actual performance in 2019-20: Blind year adjustment, final decisions, overview

Ofwat

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Contents

1. Introduction

This document presents an overview of our final decisions on the PR19 blind year adjustments, following consultation of our draft proposals published in September 2020[1]. This chapter provides an overview of the approach we took in developing, consulting and reaching our final decisions in relation to these matters.

1.1 Background

In PR14, we set mechanisms to incentivise companies to do the right thing for their customers during 2015-20. These financial incentives cover cost efficiency, outcomes performance, revenue forecasting, customer service, water trading and land sales. In setting the 2019 periodic review (PR19) final determinations, we applied reconciliation adjustments to revenues for the 2020 to 2025 period and to the regulatory capital value (RCV) to take account of how companies performed against these incentive mechanisms in 2015-20.

Many of these mechanisms required data for the last year of the price control period, 2019-20 (the blind year), to assess the financial payments between companies and customers. When the 2019 periodic review (PR19) was completed in December 2019, this financial year had not finished. As a result, companies provided forecast data, which we considered and adjusted as necessary, for inclusion in the PR19 final determinations. Companies reported their actual performance for 2019-20 alongside their Annual Performance Reports (APRs), submitted to Ofwat by 15 July 2020.

1.2 The PR19 blind year draft proposals

In September 2020, we published our PR19 blind year draft proposals, which presented our proposed assessment of the difference between the 2019-20 performance assumed in the PR19 final determinations and actual 2019-20 performance. It set out:

- the extent to which, for each company, the revenues and RCV adjustments included in the PR19 final determination for 2019-20 needed to be adjusted to reflect actual performance.
- any interventions we intended to make, and the rationale for these.

Alongside our draft proposals we published models for each reconciliation, and for the overall RCV and revenue adjustments.

[1] See 'Adjusting for company actual performance in 2019-20: Blind year adjustment - Overview'

Our approach to completing the reconciliations is set out in the 'PR14 reconciliation rulebook' (the 'reconciliation rulebook'), which we originally published in 2015 and have subsequently updated.

Chapter 2 presents an overview of the issues we consulted on as part of our PR19 blind year draft proposals, alongside a summary of responses received on these issues, and our final decisions. Further details are presented in the full suite of documents we have published alongside this overview. This includes an appendix for each company that presents our detailed final decisions on their blind year adjustments as well as the supporting models that were used to calculate the final adjustments / interventions that will be applied.

1.3 Summary of responses: PR19 blind year draft proposals

We received 17 submissions in response to the consultation; one from CCWater and the remainder from water companies. Of these respondents, 13 expressed support for our blind year draft proposals and two specifically stated that they did not have any comments on our draft proposals. Chapter 2 summarises the comments that were made regarding specific interventions and, aside from these, the following issues were raised.

- **Deferral of K:** Four companies specifically requested a deferral of some of their proposed blind year ODI revenue adjustment. They argued this would help reduce unnecessary volatility and smooth bill impacts for customers. CCWater noted that if taking ODI revenue adjustments in 2021/22 charges leads to significant bill volatility it would be supportive of smoothing these impacts. Company proposals on this issue are discussed in more detail in Chapter 3.
- **Interaction with the CMA process:** Three companies noted the interactions with the CMA process and asked for clarification about how the processes will work together. Our current position on this is presented in Section 1.5 below.
- **Indexation:** A number of companies raised issues around the treatment of the RPI CPIH wedge for 2019-20, noting that in the PR19 final determinations the RPI-CPIH wedge was set on the basis of forecast inflation and needed to be updated to reflect outturn inflation values. This is discussed in more detail in Chapter 2.
- **Modelling:** A number of specific issues were raised regarding discrete elements of the blind year models and these are discussed in more detail in Chapter 2.

1.4 Section 13 Consultation notice

Alongside the PR19 blind year draft proposals, we published a Section 13 consultation notice[2] which proposed licence changes to:

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

- 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 Revenue Forecasting Incentive (RFI) formula.
- allow unambiguous revenue errors in relation to our PR19 final determinations to also be included in the blind year adjustment figure for the RFI formula.[3]

Further details regarding the outcome of the Section 13 consultation are presented in Chapter 3, alongside an overview of the approach we will take to implementation of the PR19 blind year adjustments.

1.5 Interaction with the Competition and Markets Authority (CMA) redeterminations of price controls

Four companies, Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water, asked for our PR19 final determinations to be referred to the CMA. The CMA is considering these references and will make its own determination of the price controls for the current price control period (1 April 2020 to 31 March 2025). While the blind year adjustments relate to the last year of the previous price control period, there will be an interaction because both processes lead to changes in allowed revenue in the current price control period. Consequently, we are sharing our decision with the CMA so that they know what changes to these companies' allowed revenue we have made.

[3] We only proposed to include this item when calculating the blind year adjustment figure for Southern Water and it was therefore not included in the proposed licence changes for any other company.

2. Key interventions

This chapter presents an overview of the key interventions that we proposed in our PR19 blind year draft proposals, alongside a summary of the responses we received and our PR19 blind year final decisions.

In developing our PR19 blind year draft proposals, we reviewed company blind year submissions and, where appropriate, sought clarity on the information provided. In a small number of cases our assessment identified areas where we may need to intervene to ensure that the blind year adjustment was appropriate.

The PR19 blind year draft proposals presented our proposed interventions and invited views from companies and other stakeholders regarding the proposed approach. We received 17 submissions in response to the consultation; these were primarily from water companies as well as a response from CCWater. We have given full consideration to the issues raised by respondents in their submissions, and this chapter presents a summary of our final decisions regarding the PR19 blind year interventions.

2.1 Our final decisions on PR19 blind year interventions

Table 1 below presents a summary of the interventions that are being made, alongside final figures for the overall proposed blind year adjustment (including any interventions). In the section that follows, we provide a summary of the interventions that were presented in our PR19 blind year draft proposals, the responses that were submitted regarding each draft proposal and our final decisions regarding these interventions. Full details of the final interventions for each company are presented in the company-specific appendices.

Table 2 Blind year adjustments and key interventions by company (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

Company	Key interventions	Blind year adjustment including interventions		
		Revenue (£m)	Proportion of 2019-20 allowed revenue (%)	RCV (£m)
Anglian Water	None	-28.7	-2.2	17.2
Dŵr Cymru	We are intervening to include an underperformance payment for performance commitment 'F1 Asset Serviceability (water)'.	-7.0	-1.1	5.2
Hafren Dyfrdwy	We are intervening to ensure the modification factors in the residential retail model reflects the reallocation, between Severn Trent Water and Hafren Dyfrdwy, of parts of their regulated businesses that took place in 2018.	2.6	8.0	2.8
Northumbrian Water	None	4.4	0.5	5.9
Severn Trent Water	We are intervening to increase the underperformance payment on S-A1 (internal sewer flooding) and S-A2 (external sewer flooding). We are intervening to ensure the modification factors in the residential retail model reflects the reallocation, between Severn Trent Water and Hafren Dyfrdwy, of parts of their regulated businesses that took place in 2018.	-15.8	-1.0	-8.7
South West Water	None	-8.9	-1.6	12.0
Southern Water	We are intervening to include underperformance payments for performance commitments '13 Thanet sewers' and '15 Millbrook sludge'.	23.4	2.6	33.3
Thames Water	We are intervening to include an underperformance payment for 'WC2 Leakage'. We are intervening so that no ODI underperformance payment applies for the blind year reconciliation for WB7 (Compliance with SEMD advice notes).	33.6	1.4	57.8
United Utilities	None	-1.3	-0.1	51.0
Wessex Water	None	1.5	0.3	11.1
Yorkshire Water	None	17.7	1.6	29.4
Affinity Water	None	3.8	1.2	-1.1
Bristol Water	None	3.5	2.4	5.4
Portsmouth Water	We are intervening to reduce the outperformance payment for B1 (Leakage). We are intervening to amend the company's calculation for B1 (Per capita consumption). We also adjust for ODI payments that, in the PR19 Final Determination, were applied in 2015-18 but are	-0.8	-2.0	0.4

Company	Key interventions	Blind year adjustment including interventions		
		Revenue (£m)	Proportion of 2019-20 allowed revenue (%)	RCV (£m)
	determined from 5-year averages and are therefore updated as part of this blind year assessment. We make an adjustment to revenue recovered in 2019-20.			
South East Water	None	2.7	1.1	0.8
South Staffs Water	None	0.7	0.5	1.2
SES Water	None	-3.2	-4.7	0.4
Industry total		**28.2**	**0.2**	**224.1**

Note: As well as replacing forecast performance with actual performance in 2019-20, the company's blind year view and our blind year determinations set out in the above table also replace forecasts of inflation in 2019-20 with actual RPI and CPIH indices.

The majority of the interventions relate to performance commitments and associated ODIs. The following section presents an overview of the interventions that were presented in our PR19 blind year draft proposals, the submissions made in response to our PR19 blind year draft proposals, and our final decisions regarding these interventions.

2.1.1 Dŵr Cymru

In our PR19 blind year draft proposals, we said we Intended to intervene to apply an underperformance payment of -£2.5 million (2012-13 prices, net of tax) in relation to the 'F1 Asset serviceability - water' performance commitment. While Dŵr Cymru reported that it had met the F1 performance commitment in its 2019-20 APR, during PR19[4] we had flagged that further poor performance of a sub-measure of this performance commitment (supply interruptions > 12 hours) in 2019-20 could trigger an underperformance payment. In our PR19 blind year draft proposals we concluded that the status of the sub-measure was 'deteriorating' and the performance commitment overall was 'marginal' and so it was appropriate to apply an underperformance payment.

Summary of responses

Dŵr Cymru was the only respondent to comment on this intervention. The company stated that it remained of the view that performance of this measure should be based on the underlying trend and that it was disappointed that Ofwat had not recognised this.

[4] In our 'PR19 final determinations: Dŵr Cymru – Accounting for past delivery final decisions' (December 2019)

Finalised interventions

While we acknowledge Dŵr Cymru's view, we note that actual performance for supply interruptions has remained above the 'high level' for all five years of the PR14 price control period. In this respect, the company has failed to bring actual performance within the expected PR14 commitment levels for any single year. We consider discussions of the trend to be largely irrelevant when the performance target is not met for all years during 2015-20.

Our view remains that 2019-20 performance on the 'supply interruptions > 12 hours' sub-measure was 'deteriorating' and that Dŵr Cymru demonstrated only 'marginal' delivery of the performance commitment overall. Our final decision is to therefore intervene to apply an underperformance payment of -£2.5 million (2012-13 prices, net of tax) in relation to Dŵr Cymru's 'F1 Asset serviceability - water' performance commitment.

2.1.2 Severn Trent Water

In our PR19 blind year draft proposals, we flagged two potential interventions related to Severn Trent Water's 2019-20 blind year adjustments.

Our first proposed intervention was to apply underperformance payments (of -£0.5 million 2012-3 prices, net of tax) for the 'S-A1 Internal sewer flooding' and 'S-A2 external sewer flooding' performance commitments. We noted that in its 2019-20 APR Severn Trent Water had explained that it was using new evidence and methodologies in its process to determine the number of sewer flooding incidents to exclude from these performance commitments. The company's revised approach resulted in a small number of additional sewer flooding incidents being excluded from the performance commitments (less than 1% of the total incidents). We reviewed the evidence provided and reached the view that expansion of these methodologies did not represent a material improvement for customers. We also set out that the company had provided insufficient evidence of how the methodologies had been applied and to demonstrate the robustness of these methodologies.

The second potential intervention related to the removal of outperformance payments for the 'W-D1 Improvements in river water quality against WFD criteria' performance commitment. If applied, it would remove £0.750 million (2012-3 prices, net of tax) of outperformance for each intervention that is not delivered in excess of the performance commitment level. We noted that Severn Trent Water had reported an outperformance payment for 2019-20 for W-D1 but that the Environment Agency had advised us that the company had provided insufficient evidence of delivery of reported improvements at Battlefield Brook, Upper Worfe and Meece Brook. While the potential intervention was not included in the PR19 blind year draft proposals, we flagged its possible inclusion in our final decision if the Environment Agency remained of the view that required improvements had not been delivered satisfactorily. Recognising this, we required the company to engage the Environment Agency, ahead of our final decision, to demonstrate satisfactory delivery of these improvements.

Summary of responses

Severn Trent Water commented that some differences of opinion are inevitable – for example, whether a particular event or series of weather events can be considered exceptional.

On the second potential intervention related to the removal of outperformance payments for the W-D1 performance commitment, Severn Trent Water highlighted that the three schemes identified by Ofwat were still under discussion with the Environment Agency. In a follow-up email received on 19 October 2020, the company stated that it had received confirmation from the Environment Agency that Severn Trent Water had effectively delivered the AMP6 Water Resource schemes for Battlefield Brook, Upper Worfe and Meece Brook.

Finalised interventions

On the basis of the reasons given in our draft proposals, and the responses subsequently received, our final decision is as follows.

- We will apply underperformance payments (of -£0.5 million 2012-3 prices, net of tax) for Severn Trent Water's 'S-A1 Internal sewer flooding' and 'S-A2 external sewer flooding' performance commitments.
- We will not intervene to remove any outperformance payments for the W-D1 performance commitment.

2.1.3 Southern Water

In our PR19 blind year draft proposals we proposed to intervene to apply underperformance payments for delays to two of Southern Water's PR14 capital investments ('15 Millbrook sludge' and '13 Thanet sewers'). We proposed an underperformance payment of -£0.566 million for Millbrook Sludge and -£0.950 million for Thanet Sewers (both in 2012-13 prices, net of tax). This was in line with the PR14 final determinations which specify that, as Southern Water did not meet predefined delivery dates, it should incur underperformance payments. In setting the level of these proposed underperformance payments, however, we recognised that there was sufficient evidence that the schemes were, in large part, operational by the agreed deadline.

Southern Water had argued that delays to these two PR14 capital investments were outside of its control (due to Covid-19 restrictions) and that it should not incur underperformance payments but the company did not provide convincing evidence to support its arguments.

- While Covid-19 contributed to delays in delivering **Thanet Sewers**, previous impacts on work timelines meant that completion would not have been well in advance of the deadline, even in the absence of Covid-19.

- While Covid-19 impacted progress on delivering **Millbrook sludge**, previous impacts on work timelines meant that delivery by the deadline would have been highly unlikely, even without further issues arising.

We noted that Covid-19 only affected the last few weeks of the five year control period and full delivery of the schemes could have been secured earlier to mitigate risks of non-delivery.

Summary of responses

In its response to the blind year draft proposals Southern Water set out that it continued to believe that, in the absence of the restrictions put in place in response to Covid-19, the scheme would have been delivered in time but it accepted that this was ultimately a matter of judgement. However, the company noted that it had provided Ofwat with all of the relevant evidence and that it therefore had no choice but to accept the underperformance payment.

Southern Water considered our assessment of Thanet Sewers to be incorrect for two reasons.

- The first related to the justification we provided for the imposition of a late delivery underperformance payment and the Ofwat argument that, in the absence of Covid-19, the scheme would not have been delivered "well in advance of the deadline". In response, Southern Water noted that the ODI, as specified in the PR14 final determinations did not require the scheme to be delivered "well in advance" of 31 March 2020, but to be complete by 31 March 2020.
- Southern Water had established a clear day-by-day plan to ensure delivery of the scheme by 31 March 2020. The company highlighted that plan had been authorised for execution on 23 March 2020 and that, absent the restrictions arising from Covid-19, it would have ensured delivery by the deadline. Alongside its response Southern Water provided a copy of the day-by-day plan as well as other supporting evidence.

Finalised interventions

Our final decision is to apply an underperformance payment of -£0.566m for Millbrook Sludge and -£0.950m for Thanet Sewers. We note the points made regarding Thanet Sewers in the Southern Water response and have reviewed the additional evidence the company provided but do not consider its arguments or associated evidence to be sufficiently convincing for us to amend our proposed intervention.

Southern Water suggests that the Ofwat reference to the scheme not being delivered "well in advance of the deadline" is incorrect as the provisions of the PR14 final determinations simply require delivery of the project by 31 March 2020. However, this was not intended as a comment on the performance commitment definition, and was intended only to convey the fact that the planned delivery of the final phase of the Thanet Sewer was running so close to the deadline that any further delay, regardless of the cause, would put delivery to the deadline at risk.

The additional evidence Southern Water provided with its response indicates that it had forecast that a small quantity of work would not be complete by the deadline. A mitigation plan was therefore agreed with the main contractor working on the Thanet Sewer to install temporary measures that the company believed would deliver its obligation to prevent exfiltration by 31 March 2020. The information provided by Southern Water indicates that the mitigation plan was ready to be implemented by 1 March 2020 and that final authorisation to progress the temporary works was given on 23 March 2020.

We do not consider this additional evidence to be sufficiently convincing of the company's arguments to persuade us to amend our proposed intervention. Despite the fact that the mitigation plan was ready to be implemented from 1 March 2020, authorisation for this work was not provided until three weeks later on 23 March 2020.

We recognise that it is not possible to know with certainty whether Southern Water would have met the 31 March deadline in the absence of Covid-19 but the evidence suggests that the company did not take the steps expected of a prudent company to mitigate the risk of non-delivery and, as a result, the work was not completed on or before the deadline.

We also note that the provisions of the PR14 final determinations contain two forms of underperformance payment with respect to the delivery of the Thanet Sewers project by the 31 March 2020 deadline; one for non-delivery (£31.20 million) and one for delay (£0.95 million). In our blind year draft proposals, we did not propose intervening to apply underperformance payments for non-delivery. While we considered this option, on balance we were of the view that, while the project was not delivered by the deadline, there was sufficient evidence that the company had made substantial progress towards delivery by the specified deadline and that the project would ultimately be delivered. We remain of this view and our final decision is to therefore to apply a late delivery underperformance payment of -£0.950m for Thanet Sewers.

2.1.4 Thames Water

In our PR19 blind year draft proposals, we proposed two ODI adjustments.

The first was an intervention to exclude the impact of methodological changes and a data update, applied in Thames Water's 2019-20 APR, from its calculation of ODI incentives related to the 'W-C2 Leakage' performance commitment. This intervention led to a proposed underperformance payment of -£5.850 million (2012-13 prices, net of tax).

We noted that in August 2018 Ofwat accepted undertakings given by Thames Water to address our findings that it had breached two of its legal obligations in relation to its management of leakage reduction[5]. We also advised that, in assessing the company's 2019-

[5] Details of our investigation are presented on our website including the Notice of Ofwat's imposition of a financial penalty on Thames Water Utilities Limited

20 performance and associated ODI payments, we applied the framework and expectations set out in the PR14 final determination and subsequent policy statements. We said that this applies to all companies and is distinct from the specific undertakings Thames Water had to implement following the investigation.

In the PR19 blind year draft proposals, we highlighted a concern that methodological changes and data updates can reduce consistency and transparency for customers and other stakeholders. We noted that, when proposing such changes, companies needed to consider IN 16/07 (May 2016). This information notice sets out our policy regarding requests for changes to the performance commitments (in the 2014 price review company specific appendices) and specifies that companies must follow an agreed process. We noted that, prior to making its methodological changes and data update, Thames Water did not follow the processes set out in the Information Notice.

We also highlighted our view that companies should only receive incentive payments from the delivery of real performance improvements and that the impact on performance commitments, with and without methodological changes, should be clear. We clarified that we had taken this approach for other companies during 2015-20 and that we would apply this approach during the 2020-25 price control period.

The second intervention removed underperformance payment for WB7 (Compliance with SEMD advice notes). In this respect, we highlighted that Thames Water had included an underperformance payment in 2019-20 for WB7. We noted that this commitment had been scrutinised in PR19 in detail and that the PR19 final determination included a performance commitment for 2020-25 to deliver outputs that the company advised us during PR19 that it would not deliver by 2019-20. We were of the view that the PR19 performance commitment would expose the company to stronger underperformance incentive rates for non-delivery than would have been incurred under PR14. Therefore we considered that customers' interests would be best served if all outputs that were not forecast to be delivered at the time of the PR19 final determination were reconciled using the PR19 performance commitment to provide strong incentives to deliver.

Summary of responses

In its response, Thames Water expressed support for our view that performance must be transparent and consistent, noting that it had, at all times, acted in full compliance with the provisions of its PR14 final determinations as well as those set out in IN 16/07. The company considered that it had acted exactly in line with the expectations previously set out by Ofwat, and that its leakage performance:

- reflects 'real', not 'paper' improvements;
- is measured and recorded consistently;
- is subject to appropriate governance and assurance processes; and
- is transparent.

Thames Water highlighted that it had deliberately taken a conservative approach to reported leakage and suggested that it could have reported significantly lower leakage by including 'paper' improvements and/or extending its improved understanding of wastage to a broader set of customers.

Thames Water welcomed our proposed intervention on performance commitment WB7 (Compliance with SEMD advice notes).

Finalised interventions

On the basis of the proposed leakage intervention set out in our draft proposals, and the responses we have received, our final decision is to apply an underperformance payment of -£5.850 million (2012-13 prices, net of tax) for performance on leakage. We maintain that the framework and expectations set out in the PR14 final determination and subsequent policy statements applies for our decision on the blind year adjustment and confirm that this is distinct from our monitoring of the section 19 undertakings Thames Water had to implement following the investigation into its management of leakage reduction.

We have reviewed all of the evidence provided to us and recognise that Thames Water now has a better understanding of the allocation of water between the components of its leakage calculation. It advises that over a number of years the volume of water that should be allocated to night use and wastage has increased, which reduces the volume of water that is allocated to leakage. In 2019-20 the company applied its new understanding of the allocation of water between these components in its leakage calculation to account for increases in night use and wastage since 2015, which results in reported leakage in 2019-20 that is 24 Ml/d lower than if it had used its original assumptions.

When calculating incentive payments we consider that it is important to maintain key assumptions throughout the 2015-20 price control. This maintains consistency and transparency for stakeholders. In the case of Thames Water, its historical leakage performance, performance commitment levels and ODI rates for the 2015-20 price control period were calculated using assumptions for night use and wastage which were long-standing (since 2006). Consequently we consider that, when Thames Water made its commitment to its customers at PR14, those assumptions were not expected to change and it was incentivised to deliver reductions in leakage on the same basis. We are therefore intervening to exclude the 24 Ml/d impact of the revised assumptions from the calculation of ODI incentives for WC2 leakage. This leads to an underperformance payment of -£5.850 million (2012-13 prices, net of tax).

We also note that, regardless of which night use and wastage assumptions are applied in Thames Water's calculation of leakage, the volume of water that has been taken from the environment remains the same. We therefore do not consider that the 24 Ml/d reduction in leakage represents an improvement that the company has delivered for its customers and the environment.

Other companies have approached us with similar issues during 2015-20 and we have consistently required that, for the purpose of calculating ODI payments, the key assumptions made when setting performance commitment levels should be used. We therefore consider that all companies should only receive incentive payments from delivery of performance improvements calculated from application of the key assumptions used when they set their performance commitment levels and ODI rates.

On the second proposed intervention, to remove the underperformance payment related to WB7 (Compliance with SEMD advice notes), our approach remains unchanged from the blind year draft proposals.

Possible future intervention

On 9 November, Thames Water informed us that it had identified an issue in the reporting of its 2019-20 ‘Planned network rehabilitation’ sub-measure data (part of its WB1 (asset health water infrastructure) performance commitment). While the company continues to review this and the final position is not yet known, Thames Water has indicated that it expects that an additional underperformance payment is due.

We have not included any assumption on potential underperformance payments in our blind year assessment. We will work with the company to understand the correct performance figure and would look to include any performance payment due in future performance measure adjustments or reconcile at the 2024 periodic review (PR24).

2.1.5 Portsmouth Water

In our PR19 blind year draft proposals, we flagged two proposed interventions related to Portsmouth Water’s 2019-20 blind year adjustments.

The first was a proposed intervention to exclude the impact of methodological changes and a data update, applied in Portsmouth Water’s 2019-20 APR, from its calculation of ODI incentives related to the ‘W-C2 Leakage’ performance commitment. The intervention would reduce the company’s outperformance payment by £0.037 million (2012-13 prices, net of tax). The outperformance payment Portsmouth Water reported in its 2019-20 APR had been derived by including a methodological change which resulted in a greater reduction in leakage.

Similar to our approach on Thames Water we highlighted a concern that methodological changes and data updates can reduce consistency and transparency for stakeholders, and emphasised that companies should consider IN 16/07 when proposing such changes. We noted that Portsmouth Water had not followed these processes prior to making this change. We also specified that companies should only receive incentive payments from the delivery of real improvements and that the impact on performance commitments, with and without methodological changes, should be clear.

The second was a proposed adjustment of £0.2m to revenue recovered in 2019-20, to reflect a variance in new connections from the PR19 final determination.

Summary of responses

In its response, Portsmouth Water stated that it did not agree with Ofwat's position that the company had changed its methodology for calculating leakage. The company considered that, in its submissions to Ofwat, it had demonstrated that the leakage reduction shown in 2019-20, in particular, was the result of a genuine improvement in performance and not a consequence of a methodological change. Portsmouth Water confirmed that its leakage performance had been subject to independent third party technical assurance. The company also noted that it had been open and transparent in its reporting of leakage and expressed disappointment that it had been penalised for this.

Finalised interventions

On the basis of the proposed intervention set out in our draft proposals, and the responses we have received, our final decision is to reduce outperformance by -£0.037 million (2012-13 prices, net of tax) for performance on leakage. We note the constructive engagement we have had with Portsmouth Water during the consultation period which has enabled us to further understand the approach it has taken in deriving its reported performance for 2019-20. We also acknowledge the company's inclusion of its independent assurance report in its Outcome Delivery Incentives Performance Report which is available to customers and other stakeholders and states that new data has been applied in the calculation of leakage in 2019-20.

We have reviewed all of the evidence provided to us and recognise that Portsmouth Water now has a better understanding of the allocation of water between the components of its leakage calculation. It advises that the volume of water that it considers should be allocated to night use has been broadly increasing, which reduces the volume of water which is allocated to leakage. It has applied this new understanding in 2019-20 to account for increases in night use which results in a reported leakage figure that is 3.01 Ml/d lower than if it had used its original assumption.

When calculating incentive payments we consider that it is important to maintain key assumptions throughout the 2015-20 price control. This ensures consistency and transparency for stakeholders. In the case of Portsmouth Water, its historical performance, leakage performance commitment levels and ODI rates for the 2015-20 price control period were calculated using a fixed assumption for night use which was taken from an industry-wide 'Managing Leakage' report (the most recent report was published in 2011). Consequently we consider that, when it made its commitment to its customers at PR14, the company's use of an industry-wide fixed value for this key assumption was well-established; not expected to change and; that the company was incentivised to deliver reductions in leakage on the same basis. We are therefore intervening to exclude 3.01 Ml/d from the calculation of ODI payments for Portsmouth Water. This reduces the company's outperformance payment by £0.037 million (2012-13 prices, net of tax).

We also note that, regardless of which night use assumption is applied in Portsmouth Water's calculation of leakage, the volume of water that has been taken from the environment remains the same. We therefore do not consider that the 3.01 Ml/d reduction in leakage represents an improvement that the company has delivered for its customers and the environment.

Other companies have approached us with similar issues during 2015-20 and we have consistently required that, for the purpose of calculating ODI payments, the key assumptions made when setting performance commitment levels should be used. We therefore consider that all companies should only receive incentive payments from delivery of performance improvements calculated from application of the key assumptions used to set their performance commitment levels and ODI rates.

2.1.6 Blind year models

A number of companies raised issues regarding the specifics of the blind year models that were published alongside our blind year draft proposals. The issues raised and our response are presented in the table below.

Issue	Summary of responses	Our response
Treatment of the RPI-CPIH wedge	Six companies noted that in the PR19 final determinations the RPI-CPIH wedge was set on the basis of forecast inflation and needed to be updated to reflect 2019-20 outturn inflation values. The companies highlighted that the blind year adjustment, as calculated, did not appear to take into consideration the impact of changes in actual inflation on the March 2020 closing RCV.	We agree that further RCV and revenue adjustments are required to reconcile the difference in the RPI-CPIH wedge that was forecast in the RCV feeder models. We have included extra calculations in the PR19 blind year adjustments model to calculate the further RCV adjustment that will be included as part of the PR24 midnight adjustment. The associated revenue adjustment for the difference in respect of the return companies would have been allowed during the 2020-25 period had the closing 31 March 2020 reflected actual rather than forecast 2019-20 inflation has not been included in the PR19 blind year adjustments model. We will calculate the revenue difference in respect of the return at PR24 and

Issue	Summary of responses	Our response
		adjust it for the time value of money within an appropriate model in the PR24 modelling suite.
CPIH 'base year 2019-20' for the RFI model	South East Water noted the need to convert the wholesale revenue blind year adjustments (provided in 2017-18 average CPIH prices) to a 'base year 2019-20' figure for inclusion in the RFI model; and asked for clarification on the approach to use.	We have included an extra calculation block in the PR19 blind year adjustments model to convert the wholesale revenue blind year adjustments to the price base required for input to the RFI model.
Inflation indices in the BYA feeder models	United Utilities highlighted that the blind year RCV and revenue feeder models use different inflation indices for RPI and CPIH for 2019-20 than those in the PR19 final determinations financial model. Ofwat should update the feeder models to the same inflation assumptions in the final determinations financial model.	The 2019-20 inflation assumptions in the feeder models at PR19 final determinations were the forecast assumptions submitted by each company and were intentionally different to the financial model where we used our inflation assumptions. We have updated the 2019-20 inflation assumptions with actual inflation indices in the blind year feeder models. The updated inflation assumptions and the modifications that we have made to the blind year adjustment model to address the RPI-CPIH wedge issue will secure the appropriate treatment of inflation.
CPIH indices in the BYA model	Thames Water outlined that the November CPIH indices for 2020-25 in the in-period adjustment model were left blank; these cells should be populated with the most recent forecast.	We have populated the in-period adjustment model with a CPIH index value for November 2020 in the 2020-21 year.
Application of PR24 midnight adjustment	United Utilities noted that it was not clear which RCV the PR24 midnight adjustment for the Blind year adjustment would be applied to.	This issue will be considered as part of the PR24 methodology.

2.2 Other interventions

In the blind year draft proposals we highlighted that we had not identified any issues, and therefore did not propose any interventions, in the following areas:

- water trading revenue adjustments,
- totex menu revenue and RCV adjustments,
- residential retail revenue adjustments; and
- land sales.

Although we did not propose any interventions in these areas, a number of respondents included specific comments on these. The following sections provide an overview of these comments and our final decisions.

2.2.1 Retail revenue – summary of responses and final decision

Hafren Dyfrdwy and Severn Trent Water outlined that they had calculated retail revenue adjustments in line with the modification factors set out in their licences and noted that we had diverged from these provisions in our calculations. Both companies thought that we should use the retail modification factors that had been defined in the licence.

We understand that price controls for 2018-20 were included in the Hafren Dyfrdwy and Severn Trent Water licences because of the 2018 reallocation of parts of their regulated businesses between them. However, we note that a divergence in modification factors was implemented as part of the PR19 final determinations to account for the change in customer numbers caused by the reallocation between Severn Trent Water and Hafren Dyfrdwy of parts of their regulated businesses. As part of the blind year process, we received updated data on outturn customer numbers from Severn Trent Water and Hafren Dyfrdwy and we used these to calculate updated modification factors for 2019-20 in the exact same manner as at PR19 using updated customer numbers.

2.2.2 Land sales – summary of responses and final decision

Two companies raised issues on land sales in response to our blind year draft proposals.

- South West Water highlighted that the 2018-19 land sales value included within the blind year tables was not consistent with the APR published in that year, and that the land sales value for 2018-19 should therefore be amended. Following a review of this issue, we have included the updated land sales values for South West Water in our final blind year modelling.
- SES Water noted slight differences in our representation of the "Company BY view" as compared with its understanding of its "BY view". We reviewed this issue and identified inconsistencies in the data submitted by SES Water as part of the blind year process. We have updated the relevant data in line with the company's response to our blind year draft proposals document.

Appendix 1 sets out the proposed blind year adjustments at a sector level across each model by price control.

3. Making PR19 blind year adjustments

This chapter presents an overview of how and when the PR19 blind year adjustments will take effect as well as an overview of the outcomes of our section 13 licence change consultation.

In the PR19 reconciliation rulebook consultation, we set out how we expected PR19 blind year adjustments to be applied. In Annex 2 to the notifications of the PR19 final determinations for each company, we designated all PR14 performance commitments as in-period to allow us to adjust companies' 2020-25 price controls to reflect performance in 2019-20. Annex 3 of the PR19 final determinations set out the RFI formula for 2020-25 in relation to the network plus and water resources price controls. It includes a blind year adjustment factor (TBYA) that allows PR19 blind year revenue adjustments for other PR14 reconciliation mechanisms to be taken into account.

3.1 Approach to blind year adjustments

Our approach is intended to ensure that any adjustments are made as close as possible to when customers are impacted by company performance. Table 2 below summarises the sector level adjustments proposed and when these will feed into customer bills.

Table 2: Summary of proposed blind year adjustment and when they will be implemented (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

Type of adjustment	Value (£m)	When it applies
Total ODI revenue adjustments	-38.9	In 2021-22 via an in-period price control determination
WRFIM revenue adjustments	52.8	Over the last four years of the 2020-25 period and captured in the RFI formula blind year adjustment
Water trading revenue adjustments	0.0	
Totex menu revenue adjustments	3.5	
Other revenue adjustments	6.7	
Residential retail revenue adjustments	4.1	End-of-period revenue adjustment, captured in the Residential Retail model blind year adjustment
Total non-ODI revenue adjustments	67.1	
Total revenue adjustments	**28.2**	
Totex menu RCV adjustments	127.8	At PR24, flowing through 2025-30 price controls
Land sales RCV adjustments	13.3	
ODIs RCV adjustments	-10.5	
Other RCV adjustments	-8.2	
2019-20 RPI-CPIH wedge RCV adjustments	101.7	

Type of adjustment	Value (£m)	When it applies
Total RCV adjustments	**224.1**	

For ODI revenue adjustments, we must re-determine price controls and we have used the PR19 in-period adjustments model to calculate proposed changes to price controls. The model is published alongside this document and includes updates to reflect issues that companies raised in the PR19 reconciliation rulebook consultation. The company specific documents, also published alongside this document, set out what the impact of ODI revenue adjustments will mean for price controls. We present this alongside the other revenue adjustments that will be applied through the RFI formula across the remaining years of the price control period. Both of these adjustments will affect the revenue recovered from customers in 2020-25.

3.2 Profiling of PR19 blind year adjustments

Our information note (IN 20/06) explained that we did not expect companies to submit proposals on spreading ODI adjustments across charging years. This is because we were expecting 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.

In the PR19 blind year draft proposals we stated that if, after reviewing our proposed blind year adjustments, a company considered that there was a case for spreading the blind year ODI adjustment across two or more years, it should set out its proposals in its response. We said that companies should provide clear reasons why profiling ODI revenue adjustments would be in customers' interests.

3.2.1 Profiling of blind year adjustments – summary of responses

Four companies requested a form of ODI revenue deferral, with the intent of smoothing bills and limiting the impact of the one off recovery of underperformance payments.

- **Affinity Water:** Proposed to spread its ODI adjustment over the remaining four years of the AMP period to promote stable bill evolution in line with the widely accepted view that customers prefer bill stability. To support its proposal, Affinity Water noted that the ODI adjustment would be wholly allocated to its network plus control and, once combined with the PR19 final determinations, it would have the effect of reducing the K factor by 1.12 in year two of PR19, and increasing it by 1.13 in year three.
- **Anglian Water:** Proposed that the average bill profile for customers across the AMP would be improved by smoothing the ODI adjustment over multiple charging years and therefore requested deferral of the adjustment by one year. Anglian Water expressed a

desire to smooth the customer bill profile recognising that households value budgeting certainty and noting that other factors may contribute to further bill instability in future years.
- **Severn Trent Water:** Proposed a one year deferral based on its experience of in-period ODIs which suggests that there is a need to balance the immediacy of incentives against the impact on bills. The company notes that engagement revealed a strong preference to avoid temporary reductions and sharp increases. It also points out that the reduction in bills from deferring ODI adjustments would help mitigate upward pressure on bills as a result of the reduction in non-household demand it is forecasting for 2020-21. The company notes CCWater support for its proposed approach.
- **Hafren Dyfrdwy:** Proposed to spread the adjustment over the remainder of the AMP to smooth bills. The company notes that engagement revealed a strong preference to avoid temporary reductions and sharp increases. It also points out that the reduction in bills from deferring ODI adjustments would help mitigate upward pressure on bills as a result of the reduction in non-household demand caused by Covid-19.

In its response, CCWater was supportive, in general terms, of profiling blind year adjustments where it helps to reduce bill volatility. In subsequent email correspondence, CCWater has confirmed that it was aware of the Anglian Water and Severn Trent Water proposals to smooth the impacts of the ODI changes and noted that it was supportive of smoothing in both cases.

3.2.2 Profiling of blind year adjustments – final decisions

We accept the proposals of all four companies to defer part of their ODI revenue adjustments. Details of our approach for each company is set out in each company's specific document].

All four companies referenced previous research, undertaken for PR19, to demonstrate that customers support stable bill profiles. Severn Trent Water also referenced additional research to support its proposals. CCWater supported companies' proposals.

We also considered the request in the context of the size of the proposed ODI revenue adjustments being made. The PR19 reconciliation rulebook consultation, stated an expectation that 2020-25 ODI adjustments would need to exceed ±1% of notional regulatory equity, for us to defer the excess to a subsequent year, to mitigate extreme cashflow and bill volatility. However, companies can seek to defer any amount of ODI payments, but will need to provide sufficient justification and evidence. Our decisions on any such request will be made in light of the company's expected performance and our statutory duties.

On balance we consider that it is appropriate to allow bill profiling in these cases. It will be for these companies to take ownership of how the charges are implemented. Should any of these four companies decide in future that they wish to defer revenue adjustments beyond

2022-23, they will need to provide further supporting evidence to demonstrate that this would be in customers' interests.

3.3 Section 13 Consultation notice

In 'IN 20/06: Approach to PR19 Blind year adjustments for 2019-20 performance' we explained that we would be taking forward licence modifications which would affect the PR19 blind year adjustment process. The changes we were proposing would:

- 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.
- allow unambiguous revenue errors in relation to our final determinations to also be included in the blind year adjustment figure for the RFI formula[6]. We said that we only intended to include this item when calculating the blind year adjustment figure for Southern Water.

We issued a section 13 consultation notice for the proposed licence modifications, which was published alongside our PR19 blind year draft proposals. Our PR19 blind year draft proposals were presented on the basis that the proposed licence modification, as set out in the consultation notice, would be implemented ahead of the 15 November 2020 deadline for ODI determinations.

All 17 companies agreed to the proposed modifications, so any revenue adjustment associated with the blind year reconciliation of totex menus continues to be included in the blind year adjustment figure for the RFI formula in our final decisions.

Southern Water agreed a licence modification that also allows unambiguous revenue errors in relation to our final determinations to be included in the blind year adjustment figure for the RFI formula. Consequently the final decision for Southern Water includes an additional £6.687 million (2017-18 prices) of revenue, not included in the draft proposals.

[6] In the PR19 blind year draft proposals we noted that we only intended to include this item when calculating the blind year adjustment figure for Southern Water and flagged that it was not therefore included in the proposed licence modifications for other water companies.

A1 Appendix 1

Table A1-1: Reconciliation of PR14 incentives by PR14 price control (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

	Wholesale water			Wholesale Wastewater			Residential retail			Thames Tideway		
	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view
Revenue												
Outcome delivery incentives	-101.6	-104.7	-102.5	269.4	232.8	231.3	-4.4	-4.7	-4.7	N/A	N/A	N/A
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	-12.1	-8.1	-8.1	N/A	N/A	N/A
Wholesale revenue forecasting incentive mechanism	-34.0	-22.6	-24.0	-0.7	42.7	41.1	N/A	N/A	N/A	2.0	3.0	3.0
Totex	92.9	104.2	104.3	-54.1	-62.5	-62.5	N/A	N/A	N/A	72.3	72.9	72.9
Land sales	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	N/A	N/A	N/A	N/A	-134.7	-86.5	-134.9	N/A	N/A	N/A
PR09 blind year adjustments	-17.0	-17.0	-17.0	-27.9	-28.0	-28.0	N/A	N/A	N/A	N/A	N/A	N/A
CIS RCV inflation correction	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Water trading	0.7	7.8	0.7	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Other adjustments	0.0	0.0	0.0	-125.9	0.0	-119.3	N/A	N/A	N/A	N/A	N/A	N/A
Total	**-59.0**	**-32.3**	**-38.4**	**60.8**	**185.0**	**62.6**	**-151.3**	**-99.3**	**-147.8**	**74.2**	**75.9**	**75.9**

	Wholesale water			Wholesale Wastewater			Residential retail			Thames Tideway		
	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view	PR19 FD	Company BY view	Ofwat BY view
RCV												
Outcome delivery incentives	-29.3	-22.2	-25.1	-64.5	-89.6	-79.4	N/A	N/A	N/A	0.0	0.0	0.0
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Wholesale revenue forecasting incentive mechanism	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Totex	606.8	669.6	670.2	-719.9	-648.5	-648.3	N/A	N/A	N/A	-158.2	-165.7	-165.7
Land sales	-64.9	-54.5	-57.7	-38.4	-32.0	-32.5	N/A	N/A	N/A	0.0	0.0	0.0
Residential retail service incentive mechanism	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
PR09 blind year adjustments	60.9	61.0	61.0	76.6	76.8	76.8	N/A	N/A	N/A	N/A	N/A	N/A
CIS RCV inflation correction	-584.8	-585.8	-585.6	-736.4	-737.8	-737.8	N/A	N/A	N/A	N/A	N/A	N/A
Water trading	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Other adjustments	0.0	0.0	0.0	0.0	-87.5	-8.2	N/A	N/A	N/A	-26.5	-26.4	-26.5
2019-20 RPI-CPIH wedge RCV adjustments	N/A	N/A	34.7	N/A	N/A	63.1	N/A	N/A	N/A	N/A	N/A	4.0
Total	**-11.3**	**68.1**	**62.8**	**-1,482.6**	**-1,518.6**	**-1,429.4**	**N/A**	**N/A**	**N/A**	**-184.7**	**-192.1**	**-192.3**

Table A1-2: Ofwat's view of PR14 reconciliation adjustments for 2015-20 by PR19 price control (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

	RCV adjustments					Revenue adjustments					
	Water resources	Network plus water	Network plus wastewater	Bio-resources	Thames Tideway	Water resources	Network plus water	Network plus wastewater	Bio-resources	Residential Retail	Thames Tideway
Outcome delivery incentives	2.2	-27.3	-79.4	N/A	0.0	24.2	-126.6	231.2	0.1	-4.7	N/A
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-8.1	N/A
Wholesale revenue forecasting incentive mechanism	N/A	N/A	N/A	N/A	N/A	N/A	-24.0	41.1	N/A	N/A	3.0
Totex	62.9	607.4	-648.3	N/A	-165.7	N/A	104.3	-62.5	N/A	N/A	72.9
Land sales	-5.1	-52.5	-32.5	N/A	0.0	N/A	N/A	N/A	N/A	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-134.9	N/A
PR09 blind year adjustments	7.9	53.1	76.8	N/A	N/A	N/A	-17.0	-28.0	N/A	N/A	N/A
CIS RCV inflation correction	-59.0	-526.6	-737.8	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Water trading	N/A	N/A	N/A	N/A	N/A	0.5	0.2	N/A	N/A	N/A	N/A
Other adjustments	0.0	0.0	-8.2	N/A	-26.5	N/A	0.0	-119.3	N/A	N/A	N/A
2019-20 RPI-CPIH wedge RCV adjustments	5.0	29.6	56.1	6.9	4.0	N/A	N/A	N/A	N/A	N/A	N/A
Total	**8.8**	**54.0**	**-1,429.4**	**N/A**	**-192.3**	**24.6**	**-63.0**	**62.5**	**0.1**	**-147.8**	**75.9**

Note: These totals exclude any outcome delivery incentive revenue adjustments for business retail performance commitments.

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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