

September 2020

Northumbrian Water – Adjusting for actual performance in 2019-20: Blind year adjustment – Overview

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1. Introduction

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 PR19 was completed in December 2019, this financial year had not finished. Consequently, 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.

This document sets out our assessment of the difference between the 2019-20 performance assumed in the PR19 final determination and the actual 2019-20 performance for Northumbrian Water. It sets out:

- the extent to which the revenues and RCV adjustments we made in the PR19 final determination for these incentive mechanisms need to be adjusted to reflect actual performance¹;
- which controls these adjustments apply to; and
- the adjustments to be made ‘in period’ (that is adjustments applied during 2020-25) or as part of the 2024 price review process (leading to adjustments applied over 2025-30).

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. The adjustments also reflect the interventions and decisions that formed part of Northumbrian Water’s PR19 final determination. Alongside this document, we are publishing models for each reconciliation, and for the overall RCV and revenue adjustments, on our website.

¹ Although we made adjustments for the 2010-15 Reconciliation and SIM reconciliation in the PR19 final determination. However, beyond updating the values to take account of actual 2019-20 RPI and CPIH indices, these do not need to be adjusted as part of the blind year process.

As set out in the 'Adjusting for company actual performance in 2019-20 - Blind Year adjustment, Overview', we designated all of the PR14 performance commitments with financial incentives as being in-period for the purpose of applying the blind year adjustment for differences between the 2019-20 forecast and actual performance figures².

Generally, we expect any adjustments from the 2019-20 forecast, to account for actual figures, to be modest and these adjustments should not significantly impact bills. It is for companies to take measures to smooth the impact for their customers if any impact is larger than originally expected.

In '[IN 20/06: Approach to PR19 Blind year adjustments for 2019-20 performance](#)' we confirmed how we intended to take forward a licence modification³, which would affect the blind year adjustment process. The two changes we proposed would:

- allow any revenue adjustment associated with the blind year reconciliation of totex menus to be applied during 2020-25 by including it in the blind year adjustment figure for the RFI formula.
- Allow the correction of unambiguous revenue errors in relation to our final determinations to also be included in the blind year adjustment figure for the Revenue Forecasting Incentive (RFI) formula.

Our published documentation and supporting models for the draft proposals related to the blind year adjustments are presented on the basis that the modifications, as set out in the consultation notice, will be implemented ahead of the 15 November 2020 deadline for in-period outcome delivery incentive (ODI) determinations. If 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.

² PR14 included a protection to cap the impact ODIs could have across the five years 2015-20 for most companies. This applies to the blind year ODI adjustments. Companies classified as 'enhanced' in the 2014 price review process were not covered by the cap.

³ This was first consulted on in '[PR19 Reconciliation Rulebook Consultation – proposed approach and policy The PR19 Reconciliation rulebook](#)'

2. Proposed Blind year Adjustment for Northumbrian Water

This section sets out our assessment of the blind year adjustment for Northumbrian Water and how it will apply.

Although we assume in this document that the blind year adjustment for Northumbrian Water will be applied in the same way as for other companies, its price controls are currently being re-determined by the Competition and Markets Authority (CMA). What the CMA decides to do may therefore affect when and how the blind year adjustment is applied.

2.1 Our interventions

Each company was required to submit its view of the impact that actual reported 2019-20 performance would have on its PR19 revenue allowances when compared to the forecast level of performance that was included as part of its PR19 final determination. Using this information we have assessed what the blind year adjustment should be.

In making this assessment, we reviewed Northumbrian Water's blind year submissions and, where appropriate, sought clarity on company information. Based on this information, we are not making any interventions for Northumbrian Water. We highlight other relevant issues below.

Table 1: Blind year adjustment interventions (2017-18 prices, unless otherwise stated)

Incentive	Intervention(s)
Outcome delivery incentives (ODIs)	No interventions
Residential retail revenue	
Wholesale revenue forecasting incentive mechanism (WRFIM)	
Totex	
Land sales	

2.1.1 ODI revenue and RCV adjustments

Northumbrian Water's S-C1 (Sewage treatment works discharge compliance) performance commitment incentivises the company to maintain the capability of its assets to treat and dispose of sewage in line with permit conditions. The performance commitment definition allows the company to exclude sample failures that are the result of technical breaches. The measure is informed by the Environment Agency's view of discharge permit compliance.

During the 2019 calendar year, the Environment Agency considers Northumbrian Water had six discharge permit compliance failures. Three were due to sample shortfalls resulting from laboratory analysis which did not meet quality control standards. Samples must be taken within a specified timeframe and in this instance the company left itself insufficient time to resample and conduct the subsequent analysis. The Environment Agency has confirmed that these samples were not associated with any known environmental impact and that the operation of the three excluded wastewater treatment works was generally good. The company has excluded the three works that were subject to the sample shortfalls from reporting against its performance commitment because it considers the failures to be technical breaches.

After considering the views of the Environment Agency and the company alongside the outcomes that the performance commitment incentivises, we are satisfied with how Northumbrian Water has reported performance for S-C1 and we do not impose an underperformance payment. However, we do consider that the company could have taken earlier action in order to avoid the sample shortfalls and recommend the company considers how it can minimise future risks.

2.1.2 Totex menu revenue and RCV adjustments

We have retained a number of interventions in line with the PR19 final determination model. We requested clarification on differences between the submitted model and supporting data tables on the lines 'adjustments to totex - water: disallowables' and 'adjustments to totex - Sewerage: disallowables'. In response, Northumbrian Water provided updated tables to align with their submitted model.

2.2 The proposed Blind year adjustments

[The PR19 Reconciliation Rulebook Consultation – proposed approach and policy](#) (the 'PR19 rulebook consultation') sets out how we expect blind year adjustments to be applied. In Annex 2 to the notifications of the PR19 final determination of Price Controls for [each company](#) we designated all PR14 performance commitments

(including any changes) as in period to allow us to adjust company price controls to reflect actual performance in 2019-20. Annex 3 of the notification of the PR19 final determination for each company sets 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 that allows blind year revenue adjustments for other PR14 reconciliation mechanisms to be taken into account.

Our approach is intended to ensure that any adjustments are made as close as possible to when customers are impacted by company performance:

- **Performance commitment (ODI) revenue adjustments** will be applied to bills in the 2021-22 charging year.
- **Other wholesale revenue adjustments** related to WRFIM, PR14 water trading incentives, and the Totex menu will be included in the RFI formula and can be applied over the last four years of the 2020-25 period in manner determined by each company.
- **Other 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 form part of the midnight adjustments to RCV.

Table 2 below summarises the blind year adjustments proposed for Northumbrian Water and when these will feed through into customer bills.

Table 2: Summary of proposed blind year adjustment (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

Type of adjustment	Total Value (£m)	Control				When it applies
		Network Plus	Water resources	Residential retail	Bioresources	
ODI revenue adjustments	0.000	0.000	0.000	0.000	0.000	In 2021-22 through in-period determination of price controls
WRFIM revenue adjustments	2.313	2.313	N/A	N/A	N/A	Over the last four years of the 2020-25 period and captured within the RFI formula blind year adjustment (BYA)
Water trading revenue adjustments	0.000	0.000	0.000	N/A	N/A	
Totex menu revenue adjustments	0.573	0.573	N/A	N/A	N/A	
Other revenue adjustments	0.000	0.000	N/A	N/A	N/A	
Total	2.885	2.885	0.000	0.000	0.000	
Residential retail revenue adjustments	1.484	N/A	N/A	1.484	N/A	End-of-period revenue adjustment, captured within the Residential Retail model blind year adjustment (BYA)
Totex menu RCV adjustments	1.473	1.473	N/A	N/A	N/A	At PR24, flowing through 2025-30 price controls
Land sales RCV adjustments	-0.080	-0.080	N/A	N/A	N/A	
ODI RCV adjustments	1.063	1.063	0.000	N/A	N/A	
Other RCV adjustments	0.000	0.000	N/A	N/A	N/A	
Total	2.457	2.457	0.000	N/A	N/A	

2.3 Change in price controls

As explained in section 2.2, different elements of the blind year adjustment are recovered in different ways. With the exception of the ODI revenue adjustments, all adjustments are either recovered by companies across the remaining four years of the price control period through the RFI formula, or recovered in the following price control period. ODI revenue adjustments are recovered in 2021-22 through a performance measure adjustment determination.

Table 3 sets out the proposed changes to price controls to for Northumbrian Water to account for the blind year ODI revenue adjustments⁴.

We are using the PR19 in-period adjustments model to calculate proposed changes to price controls. The version of the model we use (and are publishing alongside this document) includes some updates to reflect issues companies raised in the PR19 rulebook consultation.

Table 3: Summary of proposed changes to the price controls for the blind year ODI revenue adjustments

Control		2020-21	2021-22	2022-23	2023-24	2024-25
Water resources (K factor)	PR19 final determination		-1.31	-1.63	-2.10	-2.03
	Revised		-1.31	-1.63	-2.10	-2.03
Water network plus (K factor)	PR19 final determination		0.39	0.28	-0.61	-0.54
	Revised		0.39	0.28	-0.61	-0.54
Wastewater network plus (k factor)	PR19 final determination		0.41	0.44	1.10	1.18
	Revised		0.41	0.44	1.10	1.18
Bioresources (sludge) - Revised total revenue (£m) – 2017-18 Nov CPIH prices	PR19 final determination		20.739	20.937	21.163	21.360
	Revised		No change	No change	No change	No change
Residential retail - Revised total revenue (£m) – nominal prices	PR19 final determination		55.981	56.711	57.407	58.098
	Revised		55.981	56.711	57.407	58.098

⁴ The starting revenue allowances for the Water resources, Water and Wastewater network plus price controls do not change – only the K factors. For the residential retail price control we propose to adjust the revenue allowed by a fixed amount instead of changing the value of any of the elements set out in the final determination of the price control. No changes are being proposed to the Bioresources price control. All wastewater ODI revenue adjustments are applied to wastewater network plus.

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.

If, after reviewing our proposed blind year adjustments, Northumbrian Water considers there is a case for spreading the blind year ODI adjustment across two or more years, it should set out its proposals in its response to this document. It should set out in full its reasons and demonstrate how it has taken the views of stakeholders into account in reaching its view.

In calculating the blind year adjustment, we calculate the adjusted PR14 reconciliation for all relevant mechanisms for the whole of the 2015-20 period with updated 2019-20 performance. We then calculate the difference between this updated view and the equivalent information from PR19 final determination.

For completeness, Annex 1 sets out how the overall PR14 reconciliation adjustments for 2015-20 differ between: (a) the PR19 final determination; (b) the values submitted by Northumbrian Water in light of 2019-20 actual performance; and (c) our assessment, net of any interventions we make. It also sets out the overall midnight adjustments to the RCV by price control.

All models used to calculate our view of the blind year adjustment are published alongside this document on our website.

3. Next steps

We welcome any written comments or representations on our proposals by 19 October 2020. Representations can be made by all stakeholders. Representations can be sent either to our inbox (PR19BlindYear@ofwat.gov.uk).

To ensure transparency, we expect companies to publish representations in full. We also intend to publish all the written representations we receive on our website once we set out final proposals.

In view of this, if respondents consider that some of the information in their representations should not be disclosed (for example, because they consider it is commercially sensitive information) they should identify that information and explain why. We would expect strong, robust reasons that are specific to the information concerned. We will take such explanations into account, but we cannot give an assurance that information included in representations will not be disclosed.

Where companies are making representations, they should consider what further evidence may be necessary to submit with their representations.

We will publish final proposals on 13 November 2020 after considering representations from all stakeholders.

Annex 1 Reconciliation of PR14 incentives for 2015-20 for Northumbrian Water

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		
	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	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	-1.2	0.3	0.3
Wholesale revenue forecasting incentive mechanism	-14.9	-12.6	-12.6	0.9	0.9	0.9	N/A	N/A	N/A
Totex	10.5	11.1	11.1	-5.3	-5.3	-5.3	N/A	N/A	N/A
Land sales	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	5.7	10.1	5.7
PR09 blind year adjustments	3.6	3.6	3.6	3.0	3.0	3.0	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
Water trading	0.0	7.1	0.0	N/A	N/A	N/A	N/A	N/A	N/A
Other adjustments	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A
Total	-0.8	9.2	2.1	-1.4	-1.4	-1.4	4.4	10.2	5.9

Blind Year adjustments: Northumbrian Water

	Wholesale water			Wholesale wastewater			Residential Retail		
	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	-1.7	-0.1	-0.1	12.0	11.5	11.5	N/A	N/A	N/A
Residential retail revenue	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
Totex	25.4	26.7	26.7	-131.8	-131.7	-131.7	N/A	N/A	N/A
Land sales	-4.9	-5.0	-5.0	0.5	0.5	0.5	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
PR09 blind year adjustments	-9.0	-9.0	-9.0	1.9	1.9	1.9	N/A	N/A	N/A
CIS RCV inflation correction	-40.9	-40.9	-40.9	-30.6	-30.6	-30.6	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
Other adjustments	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A
Total	-31.1	-28.4	-28.4	-148.0	-148.4	-148.4	N/A	N/A	N/A

Note:

These adjustments are made in line with the 'PR14 reconciliation rulebook' and reflect the interventions explained in summary in table 4.11 in 'Northumbrian Water final determination' and in detail in 'Northumbrian Water - Accounting for past delivery final decisions'.

Blind Year adjustments: Northumbrian Water

Revenue in these tables may not reconcile to the lines for 'Reconciliation of PR14 incentives, 2020-25' in table 4.12 in the 'Northumbrian Water final determination'. This is because the values in table 4.12 reflect adjustments made in the financial model for the tax treatment of the wholesale revenue forecasting incentive mechanism and totex reconciliations, and net present value profiling of the reconciliation adjustments over the 2020-25 period used for setting the allowed revenue. The treatment of tax and profiling are explained in the '[PR14 reconciliation rulebook](#)'. The revenue adjustment values shown in tables 1 and 2 below assume a single year adjustment in the first year of the 2020-25 period.

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

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	Bioresources	Water resources	Network plus water	Network plus wastewater	Bioresources	Residential Retail
Outcome delivery incentives	0.0	-0.1	11.5	N/A	0.0	0.0	0.0	0.0	-0.1
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0.3
Wholesale revenue forecasting incentive mechanism	N/A	N/A	N/A	N/A	N/A	-12.6	0.9	N/A	N/A
Totex	4.0	22.7	-131.7	N/A	N/A	11.1	-5.3	N/A	N/A
Land sales	-0.7	-4.2	0.5	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	5.7
PR09 blind year adjustments	-1.4	-7.7	1.9	N/A	N/A	3.6	3.0	N/A	N/A
CIS RCV inflation correction	-6.1	-34.8	-30.6	N/A	N/A	N/A	N/A	N/A	N/A
Water trading	N/A	N/A	N/A	N/A	0.0	0.0	N/A	N/A	N/A
Other adjustments	0.0	0.0	0.0	N/A	N/A	0.0	0.0	N/A	N/A
Total	-4.2	-24.1	-148.4	N/A	0.0	2.1	-1.4	0.0	5.9

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

Table A1-3: Ofwat's view of midnight adjustments to RCV by PR19 price control (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

	RCV adjustments			
	Water resources	Network plus water	Network plus wastewater	Bioresources
PR14 reconciliations	-4.2	-24.1	-148.4	N/A
IFRS adjustments	0.3	1.3	9.8	0.3
Midnight adjustments to RCV	-3.9	-22.8	-138.6	0.3

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

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