

September 2020

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

About this document

This document invites comments on proposals of the Water Services Regulation Authority (Ofwat) to modify Condition B (Charges) of the conditions of the appointments (licences) of the following water companies¹:

- Anglian Water Services Limited
- Dwr Cymru Cyfyngedig
- Hafren Dyfrdwy Cyfyngedig
- Northumbrian Water Limited
- Severn Trent Water Limited
- Southern Water Services Limited
- South West Water Limited
- Thames Water Utilities Limited
- United Utilities Water Limited
- Wessex Water Services Limited
- Yorkshire Water Services Limited
- Affinity Water Limited
- Bristol Water plc
- Portsmouth Water Limited
- South East Water Limited
- South Staffordshire Water plc
- Sutton and East Surrey Water plc

Our proposed licence modifications would alter the effect of the Revenue Forecasting Incentive (RFI) formula, which was notified to each of the above water companies under Condition B of their licences as part of our 2019 price review (PR19).

Under section 13 of the Water Industry Act 1991 (WIA91) we are able to modify the conditions of a company's licence if it agrees to the change we are proposing to make. This document is a Notice under section 13 of the WIA91.

¹ By "water companies" we mean companies holding appointments as water undertakers and/or sewerage undertakers under the Water Industry Act 1991.

Contents

Responding to this consultation	3
Introduction and background	4
What is the effect of the changes that we are proposing?	6
Why do we need to make our proposed changes?	8
Next steps	9
Annex: Proposed modifications	10

Responding to this consultation

We invite stakeholders to comment on our proposed modifications by no later than **5pm 26 October 2020**.

The water companies concerned should also indicate their acceptance or otherwise of the proposed modifications by this date. You can email your responses to PR19BlindYear@Ofwat.gsi.gov.uk or post them to:

PR19
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Alex Whitmarsh by email to alex.whitmarsh@ofwat.gsi.gov.uk

We will publish responses to this document on our website at www.ofwat.gov.uk. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), data protection legislation and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Introduction and background

The Revenue Forecasting Incentive (RFI) formula was set out in annex 3 of [the notification of the PR19 final determinations of price controls for each water company](#). It has effect during the 2020-2025 price control period in accordance with either paragraph 8.1A (for water only companies and Hafren Dyfrdwy) or paragraph 9.1A (for the other water and wastewater companies) of Condition B and will also be used at the 2024 price review (PR24) for reconciliation purposes.

The RFI applies to the price controls for wastewater network plus, water network plus and water resources activities.

Condition B requires water companies to set charges in a way best calculated to ensure that their revenues do not exceed the revenues allowed under the price controls set by Ofwat. It also makes it clear that, despite the limits we may set in price controls, water companies can levy charges to recover shortfalls in revenue in previous charging years that are calculated in accordance with a formula that is set by Ofwat for the relevant price control period. The RFI is the relevant formula for 2020-2025 and enables companies to correct revenue forecasting errors more quickly than would otherwise be possible.

The RFI formula includes a blind year adjustment term (TBYA). The definition of the term as set out in the formula says:

“**TBYA** = Blind year adjustment stated by Ofwat in 2017-18 year average prices. The blind year adjustment will be announced by Ofwat at a future date.

The adjustment will be based on the difference between the Appointee’s forecast and actual performance for the 2019-20 Charging Year in relation to the Wholesale Revenue Forecasting Incentive Mechanism and the Water Trading Incentive applied in relation to the 2015 to 2020 price control period. It will be a correction to the revenue allowed by Ofwat when determining, pursuant to the 2019 Periodic Review, the Price Controls for water resources and network plus activities for the five consecutive Charging Years beginning on 1 April 2020. [...]”

We subsequently identified that two changes to the RFI formula in relation to the blind year adjustment could be appropriate and consulted on the possible changes in [PR19 Reconciliation Rulebook Consultation – proposed approach and policy](#).

The first change would be 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. We received eleven 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.

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 received consultation responses from ten companies and CCW. The respondents, other than two water companies, supported such a change.

We subsequently set out our decision to proceed with the licence change in [Information notice 20/06](#) and provided further information. We also subsequently asked companies for comments on draft wording for the licence modifications.

What is the effect of the changes that we are proposing?

The wording of the licence modifications we are proposing is set out in the Annex.

We propose to amend Condition B to allow us to include additional items when we calculate and announce the blind year adjustment figure that will apply for each water company during the 2020-2025 price control period for the purposes of the RFI. These are items that we would otherwise take into account at PR24 when we set price controls for the period from 1 April 2025. There will be an effect on the amount of revenue that water companies are allowed, or incentivised, to recover over the last four years of the price control period.

The blind year adjustment in the RFI formula will only include revenue adjustments. Since we do not adjust companies' RCV in-period, RCV adjustments will be applied at PR24.

The additional items that would be included in the blind year adjustment figure are:

1. **Totex menu revenue blind year adjustment:** This means any revenue adjustment associated with the blind year reconciliation of totex menus now that we know companies actual performance for 2019-20. This item is relevant for all 17 water companies listed on page 1.
2. **Correction of unambiguous revenue errors:** This means the correction of any unambiguous revenue error that we made when setting our PR19 final determinations of price controls. We only intend to include this item when calculating the blind year adjustment figure for Southern Water and it is therefore not included in the proposed licence modifications for other water companies. (If we are persuaded that an unambiguous revenue error should be included in the blind year adjustment for another water company then we would need to propose a new licence modification for that company.)

In the case of both additional items, we have set how these would be used and their impact as part of the [blind year consultation](#)².

Affected price controls: The RFI formula only applies to the price controls for water resources and network plus activities. The residential retail blind year adjustment will

² Further details are available from 'Adjusting for company actual performance in 2019-20 - Blind Year adjustment, Overview' and 'Southern Water: Adjusting for actual performance in 2019-20, Blind Year adjustment'.

be applied as an end-of-period adjustment at PR24 in the PR19 residential retail reconciliation model.

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 judge each case on its merits. That said, we have recognised that some guidance is helpful to stakeholders. In [Information Notice 20/06](#) we said, 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 excludes errors that require significant analysis or judgement in order to determine if they are truly an error or their magnitude. Furthermore, the blind year adjustment process is not a chance to revisit regulatory judgements and therefore it excludes any issue we were aware of before we made our final determinations.

Future effect: It is important to note that the setting of the blind year adjustment figure for the purposes of the RFI formula is a one-off event – we cannot change the blind year adjustment figures once we have set them. Where appropriate, we can take adjustments, such as unambiguous revenue errors, into account at PR24 when setting price controls for the period from 1 April 2025.

Severn Trent Water and Hafren Dyfrdwy: For each of Severn Trent Water and Hafren Dyfrdwy we propose that our licence modification will replace the existing Part IX of Condition B (entitled “Price controls in effect from the Charging Year starting on 1 April 2018”) and the associated Schedule with a new Part IX. The existing Part IX and the associated Schedule set out the price controls for the period from 1 April 2018 to 31 March 2020 and are now redundant.

Why do we need to make our proposed changes?

A licence modification is required to change the definition of the blind year adjustment in the RFI formula because the formula has been formally notified to water companies and the relevant deadline³ in Condition B has passed.

We are proposing to include the totex menu revenue blind year adjustment because we consider that it is appropriate to apply 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.

We are proposing to include the correction of unambiguous revenue errors for Southern Water because we consider that 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. We do not think that it is proportionate to include the correction of unambiguous revenue errors in the licence modification for other water companies when we are not proposing to include any such correction in their blind year adjustment figure.

Although licence conditions can differ between water companies, we are proposing to replace the existing Part IX of Condition B for Severn Trent Water and Hafren Dyfrdwy in the interests of simplification and greater consistency between water companies in relation to Condition B. We also consider that it is sensible to take appropriate opportunities to remove redundant provisions from licence conditions.

³ The deadline by which the RFI formula needed to be notified to companies was 31 December 2019 – the 31 December before the start of the 2020-2025 price control period (see paragraph 8.1A (for water only companies and Hafren Dyfrdwy) or paragraph 9.1A (for the other water and wastewater companies) of Condition B).

Next steps

We would like responses to this document, including formal agreement to our proposals from those companies that wish to proceed with the licence modification, by no later than **5pm 26 October 2020**.

Subject to the responses to this consultation and the agreement of the companies concerned, we expect to amend companies' licences by 15 November 2020.

Annex: Proposed modifications

This annex sets out the proposed wording of the modifications to Condition B for the relevant companies.

Where alternative paragraph numbers are shown (e.g. “[8.1A/9.1A]”), the lower paragraph number relates to Condition B for water only companies and Hafren Dyfrdwy and the higher paragraph number relates to Condition B for the other water and sewerage companies.

Totex menu only modification

New text to be inserted at the end of Condition B:

“Part IX Changes to the Revenue Forecasting Incentive formula

[20/21] The formula notified to the Appointee for the purposes of sub-paragraph [8.1A/9.1A] of this Condition in relation to the Charging Years beginning on 1 April 2021, 1 April 2022, 1 April 2023 and 1 April 2024 shall have effect as if the definition of TBYA (the blind year adjustment to be announced by Ofwat) provided that the adjustment will be based on the items listed in the definition and the difference between the Appointee’s forecast and actual performance for the Charging Year beginning on 1 April 2019 in relation to the revenue adjustments arising from the totex menu model applied in relation to Price Controls for the five consecutive Charging Years beginning on 1 April 2015.”

Notes:

1. This wording is proposed for all of the water companies listed on page 1 except Southern Water.
2. For each of Severn Trent Water and Hafren Dyfrdwy this new text would replace the existing Part IX of Condition B (entitled “Price controls in effect from the Charging Year starting on 1 April 2018”) and the associated Schedule.

Totex menu and unambiguous revenue errors modification

New text to be inserted at the end of Condition B:

“Part IX Changes to the Revenue Forecasting Incentive formula

- 21 The formula notified to the Appointee for the purposes of sub-paragraph 9.1A of this Condition in relation to the Charging Years beginning on 1 April 2021, 1 April 2022, 1 April 2023 and 1 April 2024 shall have effect as if the definition of TBYA (the blind year adjustment to be announced by Ofwat) provided that the adjustment will be based on the items listed in the definition and:
- (a) the difference between the Appointee’s forecast and actual performance for the Charging Year beginning on 1 April 2019 in relation to the revenue adjustments arising from the totex menu model applied in relation to Price Controls for the five consecutive Charging Years beginning on 1 April 2015; and
 - (b) the correction of any unambiguous revenue errors in relation to the revenue allowed to the Appointee that the Water Services Regulation Authority made when determining the Price Controls for the five consecutive Charging Years beginning on 1 April 2020.”

Note:

1. This wording is only proposed for Southern Water.

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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