

September 2020

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

Severn Trent Water: Adjusting for actual performance in 2019-20, Blind year adjustment Overview

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 Severn Trent 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 Severn Trent 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 '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 Revenue Forecasting Incentive (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 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 Severn Trent Water

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

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 Severn Trent Water's blind year submissions and, where appropriate, sought clarity on company information. Where necessary we are proposing to intervene to ensure the blind year adjustments are appropriate. We summarise our proposed interventions for Severn Trent Water in table 1 below.

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

Incentive	Intervention(s)
Outcome delivery incentives (ODIs)	We are intervening to increase the underperformance payments on 'S-A1 internal sewer flooding' and 'S-A2 external sewer flooding' We identify potential interventions on W-D1 (improvements in river water quality against WFD criteria), which we will consider for our final decision
Residential retail revenue	We are intervening to set new modification factors for Severn Trent Water to reflect the changes to its regulated business that took place in 2018.
Wholesale revenue forecasting incentive mechanism (WRFIM)	No interventions
Totex	No interventions
Land sales	No interventions

2.1.1 ODI revenue and RCV adjustments

We are intervening to increase underperformance on Severn Trent Water's **S-A1 (internal sewer flooding)** and **S-A2 (external sewer flooding)** performance commitments.

S-A1 and S-A2 allow sewer flooding incidents to be excluded when they are caused by exceptionally severe weather (ie greater than a 1 in 20 return period). In 2019-20, as a result of an exceptionally wet year, Severn Trent Water proposes to extend this definition to include the impact of multiple rainfall events with individual return periods of less than 1 in 20 years but with a cumulative rarity of greater than 1 in 20 years.

The company proposes three new sources of evidence and associated methodologies for determining such exclusions within its [2019-20 APR](#). It also described its proposed approach to us earlier this year and we committed to reviewing all of this evidence as part of our assessment of APRs. In total, the company has excluded 7 and 52 incidents from the incidents it has included in its 2019-20 APR for S-A1 and S-A2 respectively. This is equivalent to less than 1% of the total number of incidents across both performance commitments.

We reviewed all of the evidence the company provided and, overall, we consider that expansion of the methodologies used to determine exclusions does not represent a material improvement for customers. We also consider there is insufficient evidence of the number of exclusions that have been applied as a result of each methodology or that each methodology is sufficiently robust.

We are therefore intervening to apply the underperformance payments associated with the excluded internal and external sewer flooding incidents, this is -£0.300 million for S-A1 and -£0.154 million for S-A2.

The intervention for S-A1 is calculated as $(7 * -£0.042820 \text{ million})$, where -£0.042820 million is the underperformance incentive rate (£/number of incidents/year).

The intervention for S-A2 is calculated as $(52 * -£0.002967 \text{ million})$, where -£0.002967 million is the underperformance incentive rate (£/number of incidents/year).

For the final decision on blind year ODI revenue adjustments, we will also consider an intervention on Severn Trent's **W-D1 (improvements in river water quality against WFD criteria)** performance commitment.

The W-D1 performance commitment measures the number of water framework directive (WFD) improvements Severn Trent Water delivers attributable to improvements in flow, with a point scored for each classification improvement. Points are scored for improvements as agreed with the Environment Agency.

In 2019-20, Severn Trent Water reports 33 points against a performance commitment level of 31. The Environment Agency advises that Severn Trent Water reports points for Battlefield Brook, Upper Worfe and Meece Brook within its reported performance. But we are advised by the Environment Agency that:

- The company has not provided a completion report for Battlefield Brook
- There is insufficient evidence that Upper Worfe has been completed to the required specification.
- There is insufficient evidence that required monitoring has been taking place at Meece Brook post its completion.

We require the company to engage with the Environment Agency to demonstrate that these improvements were delivered to the specifications and timescales agreed. We have not included interventions to remove outperformance payments for these three improvements in our draft decision. However, for our final decision, we will intervene to adjust ODI payments for W-D1 if we consider that there remains insufficient evidence that these improvements have been delivered to the Environment Agency's satisfaction. We will intervene to remove £0.750 m (2012-3 prices, net of tax) of outperformance for each improvement that is not delivered in excess of the performance commitment level.

2.1.2 Residential retail revenue adjustments

We are intervening to set new modification factors in residential retail for Severn Trent Water, in the same way that we did as part of the PR19 past delivery reconciliation. The modification factors provided Severn Trent Water and Hafren Dyfrdwy provided did not reflect the reallocation of regulated businesses that took place in 2018.

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 Severn Trent 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	-17.664	-18.082	0.421	0.000	-0.003	In 2021-22 through in-period determination of price controls
WRFIM revenue adjustments	-2.499	-2.499	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	5.232	5.232	N/A	N/A	N/A	
Other revenue adjustments	0.000	0.000	N/A	N/A	N/A	
Total	-14.931	-15.349	0.421	0.000	-0.003	
Residential retail revenue adjustments	-0.914	N/A	N/A	-0.914	N/A	End-of-period revenue adjustment, captured within the Residential Retail model blind year adjustment (BYA)
Totex menu RCV adjustments	14.562	14.562	N/A	N/A	N/A	At PR24, flowing through 2025-30 price controls
Land sales RCV adjustments	-0.409	-0.409	N/A	N/A	N/A	
ODI RCV adjustments	0.000	0.000	0.000	N/A	N/A	
Other RCV adjustments	0.000	0.000	N/A	N/A	N/A	
Total	14.153	14.153	0.000	N/A	N/A	

2.3 Change in price controls

As explained in section 2.1, 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 for Severn Trent 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		3.45	6.02	5.95	-7.80
	Revised		4.12	5.35	5.95	-7.80
Water network plus (K factor)	PR19 final determination		-0.50	-1.63	-1.70	0.28
	Revised		-0.82	-1.31	-1.70	0.28
Wastewater network plus (k factor)	PR19 final determination		-1.85	-1.29	-0.98	1.02
	Revised		-4.76	1.73	-0.98	1.02
Bioresources (sludge) - Revised total revenue (£m) – 2017-18 Nov CPIH prices	PR19 final determination		76.857	77.205	77.395	77.744
	Revised		No change	No change	No change	No change
Residential retail - Revised total revenue (£m) – nominal prices	PR19 final determination		105.067	106.062	107.008	107.922
	Revised		105.067	106.062	107.008	107.922

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, Severn Trent 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 Severn Trent 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 15 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 by 13 November 2020 after considering representations from all stakeholders.

Annex 1 Reconciliation of PR14 incentives for 2015-20 for Severn Trent 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	-4.9	-6.1	-6.1	159.7	143.4	142.9	0.0	0.0	0.0
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	-7.5	-8.4	-8.4
Wholesale revenue forecasting incentive mechanism	-11.5	-16.2	-16.2	-12.7	-10.5	-10.5	N/A	N/A	N/A
Totex	34.4	39.6	39.6	-20.2	-20.2	-20.2	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	-15.7	0.0	-15.7
PR09 blind year adjustments	-7.2	-7.2	-7.2	1.7	1.7	1.7	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	0.0	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	10.8	10.1	10.1	128.5	114.4	113.9	-23.2	-8.4	-24.1

Blind Year adjustments: Severn Trent 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	-4.8	-4.8	-4.8	0.0	0.0	0.0	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	127.8	149.4	149.4	-198.0	-204.8	-204.8	N/A	N/A	N/A
Land sales	-10.4	-11.0	-11.0	-15.3	-15.0	-15.0	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	10.7	10.7	10.7	1.0	1.0	1.0	N/A	N/A	N/A
CIS RCV inflation correction	-71.3	-71.1	-71.1	-79.9	-79.7	-79.7	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	52.1	73.2	73.2	-292.2	-298.6	-298.6	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 'Severn Trent Water final determination' and in detail in 'Severn Trent Water - Accounting for past delivery final decisions'.

Blind Year adjustments: Severn Trent Water

Revenue in these tables may not reconcile to the lines for 'Reconciliation of PR14 incentives, 2020-25' in table 4.12 in the 'Severn Trent 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	-4.8	0.0	N/A	12.7	-18.8	142.8	0.1	0.0
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-8.4
Wholesale revenue forecasting incentive mechanism	N/A	N/A	N/A	N/A	N/A	-16.2	-10.5	N/A	N/A
Totex	12.5	136.8	-204.8	N/A	N/A	39.6	-20.2	N/A	N/A
Land sales	-0.9	-10.1	-15.0	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	-15.7
PR09 blind year adjustments	0.9	9.8	1.0	N/A	N/A	-7.2	1.7	N/A	N/A
CIS RCV inflation correction	-6.0	-65.1	-79.7	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	6.5	66.6	-298.6	N/A	12.7	-2.6	113.8	0.1	-24.1

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	6.5	66.6	-298.6	N/A
IFRS adjustments	0.5	2.5	0.5	0.0
Midnight adjustments to RCV	7.0	69.1	-298.1	0.0

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

September 2020

© Crown copyright 2020

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gov.uk.

