

September 2020

Southern 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 Southern 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 Southern 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 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.

Our draft proposals for Southern Water identify an unambiguous revenue error, explained in section 2.1.3, which we will include in our final blind year adjustment subject to the above. For the avoidance of doubt this is not included in the blind year adjustment shown in this document.

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 Southern Water

This section sets out our assessment of the blind year adjustment for Southern 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 Southern 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 Southern 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 include underperformance payments for performance commitments '13 Thanet sewers' and '15 Millbrook sludge'.
Residential retail revenue	No interventions
Wholesale revenue forecasting incentive mechanism (WRFIM)	No interventions
Totex	We are intervening to reflect updated data from Southern Water.
Land sales	No interventions

2.1.1 ODI revenue and RCV adjustments

We are intervening to include underperformance payments for performance commitments 13 (Thanet sewers) and 15 (Millbrook sludge).

As part of its submission, Southern Water argues that delays to these PR14 capital investments were outside of its control (due to COVID-19 restrictions). The

provisions of the PR14 final determinations specify that, as Southern Water did not meet predefined delivery dates, it should incur underperformance payments. However the company proposes that it should not incur these payments due to the impact of COVID-19 restrictions.

The Thanet sewers performance commitment protects customers from delay and non-delivery of an investment to deliver a National Environment Programme (NEP4) scheme for protection of groundwater from sewer exfiltration. The investment was funded by a £37.6 million cost adjustment claim allowance made at PR14. The Millbrook sludge performance commitment protects customers from non-delivery of an investment to deliver capacity to process 6,000 tonnes of dry solids at Millbrook wastewater treatment works. The investment was funded by an £18.1 million cost adjustment claim allowance made at PR14. Each performance commitment requires the company to have delivered the investments by 31 March 2020. Several delays impacted each project.

For Thanet sewers, once a contractor was appointed in June 2018, it was identified that the scope of the work required was much greater than the company anticipated. This was compounded by issues associated with obtaining permission for road closures due to competing demand from other infrastructure schemes. Consequently, delivery of the investment was pushed to the end of the five year period and was subject to delays that created a risk that if, even minor, further issues crystallised they would jeopardise delivery by the agreed deadline. This view is supported by the company's external assurance provider. Following the delay, Southern Water has confirmed that the investment was delivered in June 2020.

We consider that, while COVID-19 did contribute to the delay in delivering this investment, 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. On this basis we are intervening to apply an underperformance payment of -£0.950 million (2012-13 prices, net of tax) for the late delivery of Thanet sewers. We do not impose underperformance for non-delivery to reflect our view that, while the project was not delivered by the deadline, there is sufficient evidence that the company had made substantial progress towards delivery by the specified deadline.

For Millbrook sludge, once a contractor was appointed in December 2017, the allowed contingency was absorbed by difficult ground conditions, design changes, delayed procurement of sub-contractors and supply chain performance issues. There is little or no evidence to demonstrate that the investment was programmed for delivery on or before 31 March 2020 and the company's external assurer was not able to confirm that delivery by that date was achievable. Southern Water has confirmed that Millbrook sludge has been operational since 30 April 2020 but that full completion and takeover from the contractor is not anticipated until autumn 2020.

We consider that, while COVID-19 impacted progress on delivering this investment, previous impacts on work timelines meant that delivery by the deadline would have been highly unlikely, even without further issues arising. On this basis we are intervening to apply an underperformance payment of -£0.566 million (2012-13 prices, net of tax) for the late delivery of Millbrook sludge.

The underperformance payment for Millbrook sludge is determined from the 5% of expected outturn costs that had not yet been incurred at 31 March 2020. The underperformance payment is therefore calculated as 5% of the £18.132 million cost adjustment made at PR14. This is then subject to cost sharing and uplifted by 25%, as per the underperformance rate specified in the final determination.

2.1.2 Totex menu revenue and RCV adjustments

We have retained a number of interventions that were included in the final determination model. We requested some additional clarification on differences between the submitted model and supporting data tables regarding third party services (capex). Southern Water provided an adequate rationale for these differences and the changes have therefore been reflected in the Ofwat modelling. Further clarification on differences related to transitional expenditure was also requested. In response, Southern Water updated the 2014-15 transitional expenditure with 2019-20 transitional expenditure and this adjustment has been made to 2019-20 actual totex.

2.1.3 Other adjustments

An unambiguous error was identified in Southern Water's PR19 final determination in the way revenue was returned to customers (following serious failures in the operation of its sewage treatment sites and for deliberately misreporting its performance) and treated within our modelling for the PR19 final determination. The amount recovered from the company was £6.683 million (2017-18 prices) too high because the input value for the penalty had already been discounted at the cost of capital but the final determination modelling had applied this discount again. Subject to the company agreeing to the licence modifications proposed in the formal consultation notice, we will include this revenue adjustment in our final decision.

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 Southern 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	-5.084	-5.084	0.000	0.000	0.000	In 2021-22 through in-period determination of price controls
WRFIM revenue adjustments	25.337	25.337	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	-4.401	-4.401	N/A	N/A	N/A	
Other revenue adjustments	0.000	0.000	N/A	N/A	N/A	
Total	15.852	15.852	0.000	0.000	0.000	
Residential retail revenue adjustments	0.887	N/A	N/A	0.887	N/A	End-of-period revenue adjustment, captured within the Residential Retail model blind year adjustment (BYA)
Totex menu RCV adjustments	34.886	34.886	N/A	N/A	N/A	At PR24, flowing through 2025-30 price controls
Land sales RCV adjustments	-0.218	-0.218	N/A	N/A	N/A	
ODI RCV adjustments	-4.437	-4.437	0.000	N/A	N/A	
Other RCV adjustments	0.000	0.000	N/A	N/A	N/A	
Total	30.231	30.231	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 for Southern 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		-2.04	2.55	-0.51	-1.63
	Revised		-2.04	2.55	-0.51	-1.63
Water network plus (K factor)	PR19 final determination		0.83	0.29	-1.95	-1.55
	Revised		0.83	0.29	-1.95	-1.55
Wastewater network plus (k factor)	PR19 final determination		2.40	-1.06	-1.19	-1.05
	Revised		0.97	0.35	-1.19	-1.05
Bioresources (sludge) - Revised total revenue (£m) – 2017-18 Nov CPIH prices	PR19 final determination		46.880	47.216	47.664	48.187
	Revised		No change	No change	No change	No change
Residential retail - Revised total revenue (£m) – nominal prices	PR19 final determination		50.921	51.613	52.257	52.911
	Revised		50.921	51.613	52.257	52.911

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, Southern 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 Southern 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 by 13 November 2020 after considering representations from all stakeholders.

Annex 1 Reconciliation of PR14 incentives for 2015-20 for Southern 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	4.4	4.4	4.4	-2.3	-7.3	-7.3	0.0	0.0	0.0
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	2.7	3.6	3.6
Wholesale revenue forecasting incentive mechanism	0.4	9.7	9.7	-0.5	15.5	15.5	N/A	N/A	N/A
Totex	-4.1	-4.5	-4.3	0.6	-3.6	-3.6	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	-33.0	-41.7	-33.0
PR09 blind year adjustments	-0.9	-0.9	-0.9	-4.7	-4.7	-4.7	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	-125.9	0.0	-126.0	N/A	N/A	N/A
Total	-0.1	8.7	8.9	-132.8	-0.1	-126.0	-30.3	-38.1	-29.4

Blind Year adjustments: Southern 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	0.0	-0.2	-0.2	0.0	-2.5	-4.2	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	31.8	37.1	37.3	-94.4	-65.2	-65.0	N/A	N/A	N/A
Land sales	0.0	0.0	0.0	0.1	-0.1	-0.1	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	-1.5	-1.5	-1.5	22.5	22.6	22.6	N/A	N/A	N/A
CIS RCV inflation correction	-29.0	-29.0	-29.0	-71.4	-71.4	-71.4	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	1.4	6.4	6.6	-143.2	-116.7	-118.2	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 'Southern Water final determination' and in detail in 'Southern Water - Accounting for past delivery final decisions'.

Blind Year adjustments: Southern Water

Revenue in these tables may not reconcile to the lines for 'Reconciliation of PR14 incentives, 2020-25' in table 4.12 in the 'Southern 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	-0.2	-4.2	N/A	7.9	-3.5	-7.3	0.0	0.0
Residential retail revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3.6
Wholesale revenue forecasting incentive mechanism	N/A	N/A	N/A	N/A	N/A	9.7	15.5	N/A	N/A
Totex	3.0	34.3	-65.0	N/A	N/A	-4.3	-3.6	N/A	N/A
Land sales	0.0	0.0	-0.1	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	-33.0
PR09 blind year adjustments	-0.1	-1.3	22.6	N/A	N/A	-0.9	-4.7	N/A	N/A
CIS RCV inflation correction	-2.3	-26.6	-71.4	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	-126.0	N/A	N/A
Total	0.5	6.1	-118.2	N/A	7.9	1.0	-126.0	0.0	-29.4

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	0.5	6.1	-118.2	N/A
IFRS adjustments	0.0	0.0	16.1	0.0
Midnight adjustments to RCV	0.5	6.1	-102.1	0.0

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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