

November 2020

South East Water – Adjusting for actual performance in 2019–20: Blind year adjustment, final decisions

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1. Introduction

This document sets out our final decisions on the reconciliation for South East Water Limited (South East Water) for the 2019–20 charging year. It includes our final determination under Part 3A of Condition B of the level of change to the price controls in respect of the company's performance in that year against its performance commitments and outcome delivery incentives (ODIs) and the blind year adjustment (TBYA) to be included in the Revenue Forecasting Incentive (RFI) formula. The specific changes, and our reasons for these are set out in full in this document.

In September 2020, we published our PR19 blind year draft proposals in [South East Water - Adjusting for actual performance in 2019–20: Blind year adjustment](#) (the PR19 blind year draft proposals). This chapter presents an overview of the approach we have taken in developing, consulting, and reaching a final position on our PR19 blind year final decisions.

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 determinations¹, 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 an overview of our 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 performance². It also

¹ The full suite of PR19 final determination documents are available [here](#).

² Our approach to the reconciliations, is set out in the '[PR14 reconciliation rulebook](#)' (the 'reconciliation rulebook').

presented our draft proposals regarding any interventions we intended to make, and the rationale for these.

Our published PR19 blind year draft proposals comprised a suite of documents to provide transparency to water companies and other interested stakeholders regarding our decisions and associated rationale. This included an overview document presenting a summary of our proposed sector wide blind year adjustments, an annex for each company presenting their adjustments and interventions, and supporting models for each company.

This document presents our PR19 blind year final decisions with respect to our assessment of the difference between 2019-20 performance assumed in the PR19 final determinations and the actual 2019-20 performance for South East Water. It sets out:

- the extent to which revenue and RCV for the incentive mechanisms specified in section 1.1, that were presented in the PR19 final determinations, will need to be adjusted to reflect actual performance in 2019-20;
- details of the controls to which these adjustments will apply; and
- the adjustments that will be made ‘in period’ (during 2020-25) or as part of the 2024 price review process (during 2025-30).

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 blind year adjustments for differences between the 2019-20 forecast and actual performance figures. In the PR19 blind year draft proposals we set out that we expected any adjustments from the 2019-20 forecast, to account for actual figures to be modest and that these adjustments should not significantly impact bills. We noted that each company had responsibility for taking measures to smooth the impact for their customers if any impact is larger than originally expected. Further details regarding the responses we received, our final decisions and how / when the PR19 blind year adjustments will be made are presented in Chapter 2.

We have adopted a similar approach to the PR19 blind year draft proposals for our final decision, so alongside this document, we have published final models for each reconciliation, and for the overall RCV and revenue adjustments.

1.3 Summary of South East Water response

In its response to the blind year draft proposals South East Water stated that it was in general agreement with the base adjustment numbers. In particular, it specified its agreement with the revised K’s for the ODI adjustments, the proposed blind year adjustment to be applied via the RFI mechanism, and the retail revenue and RCV adjustments to be applied at PR24. It had two main comments on the proposals. The first was to request clarification on the approach it should use to input blind year adjustment as ‘base year 2019-20’ in the latest published

version of the RFI model. The second related to a concern that the proposed blind year adjustment did not include provision to account for the difference between forecast and actual inflation for 2019-20. Both of these issues 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](#)³ which proposed licence changes to 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.

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. We set out that, if the proposed licence modifications were not made, the blind year revenue adjustments for totex menus would not be corrected for until the 2024 periodic review (PR24).

South East Water accepted the modification, so any revenue adjustment associated with the blind year reconciliation of totex menus continue to be included in the blind year adjustment figure for the RFI formula in our final decisions.

³ Consultation under section 13 of the Water Industry Act 1991 on proposed modifications to Condition B of the licences of 17 water companies.

2. Final decision on PR19 blind year adjustment

This chapter presents our assessment of the blind year adjustment for South East Water, provides an overview of comments submitted in response to our PR19 blind year draft proposals and confirms our PR19 blind year final decisions regarding the application of adjustments to the company.

2.1 Our final decisions on PR19 blind year interventions

Each company was required to submit, alongside their APR, 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 completed an assessment of the required blind year adjustment.

In making this assessment, we reviewed South Easter Water’s blind year submissions and, where appropriate, sought clarity on company information. Our PR19 blind year draft proposals did not include any interventions for South Easter Water and we sought the views of interested parties on our proposed approach. Following a review of responses received, we confirm that we will not be making any interventions to the company’s PR19 final determinations. An overview of our decision and the associated rationale is presented 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 Totex menu revenue and RCV adjustments

In the blind year draft proposals we specified our intent to retain a number of interventions in the water menu choice ratio, in line with the PR19 final determination model.

Summary of responses

We did not receive any specific comments on this issue.

Final position

Our final position remains unchanged from the blind year draft proposals.

2.1.2 Base year 2019–20 in RFI model

In its response to the blind year draft proposals South East Water requested clarification on the approach it should use to input blind year adjustments as ‘base year 2019–20’ in the latest published version of the RFI model. The company noted that it would need to convert the adjustment value provided by Ofwat in 2017–18 average CPIH prices to a ‘base year 2019–20’ figure for the RFI model. In this respect, it highlighted that conversion to ‘base year 2019–20’ could legitimately be done using either an average–average uplift or a Nov–Nov uplift. The company therefore requested clarification on the approach that it should use.

Final position

We have included extra calculations 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.

2.1.3 RPI–CPIH wedge

A number of companies noted that in the PR19 final determinations the RPI–CPIH wedge was set on the basis of forecast inflation and should be updated to reflect 2019–20 outturn inflation values. In this respect, 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.

Following an assessment of the responses received, we reviewed the models (a) used in the PR19 final determination, (b) used in the PR19 blind year process and (c) consulted on as part of the PR19 reconciliation rulebook. Our review highlighted that the points raised by these companies were valid and 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 adjust it for the time value of money within an appropriate model in the PR24 modelling suite.

2.2 Implementing the PR19 blind year adjustments

In the PR19 rulebook consultation, we set out how we expected blind year adjustments to be applied. In Annex 2 to the notification of the PR19 final determination for each company, we designated all PR14 performance commitments as in-period to allow us to adjust company price controls to reflect performance in 2019-20. Annex 3 of that notification also 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 PR19 blind year revenue adjustments for other PR14 reconciliation mechanisms to be taken into account.

We have included extra calculations in the PR19 blind year adjustments model to convert, using CPIH, the wholesale revenue blind year adjustments to the price base required for input to the revenue forecasting incentive (RFI) model. The RFI model inputs are defined as 'base year 2019/20 prices' that is the November prior to 2019-20 (i.e. November 2018). Companies should use these values as inputs to their RFI models.

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 blind year adjustments for South East Water and when these will feed into customer bills while table A1-4 in appendix A1 presents the company's total blind year adjustment (TBYA) allocated to each price control.

Table 2: Summary of 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	
Total ODI revenue adjustments	0.403	0.427	0.000	-0.023		In 2021-22 through in-period determination of price controls
WRFIM revenue adjustments	1.095	1.095	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		
Totex menu revenue adjustments	0.055	0.055	N/A	N/A		
Other revenue adjustments	0.000	0.000	N/A	N/A		
Residential retail revenue adjustments	1.169	N/A	N/A	1.169		End-of-period revenue adjustment, captured within the Residential Retail model blind year adjustment (BYA)
Total non-ODI revenue adjustments	2.319	1.150	0.000	1.169		
Total revenue adjustments	2.722	1.576	0.000	1.146		
Totex menu RCV adjustments	0.353	0.353	N/A	N/A		At PR24, flowing through 2025-30 price controls
Land sales RCV adjustments	0.001	0.001	N/A	N/A		
ODIs RCV adjustments	0.097	0.097	0.000	N/A		
Other RCV adjustments	0.000	0.000	N/A	N/A		
2019-20 RPI-CPIH wedge RCV adjustments	0.302	0.287	0.015	N/A		

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Type of adjustment	Total Value (£m)	Control				When it applies
		Network Plus	Water resources	Residential retail	Bioresources	
Total RCV adjustments	0.753	0.738	0.015	N/A		

2.3 Change in price controls

As outlined 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. For PR19 blind year ODI revenue adjustments, the starting assumption is that these will be recovered in 2021-22 through a performance measure adjustment determination.

Table 3 sets out the changes to price controls for South East Water to account for the blind year ODI revenue adjustments⁴. We have used the PR19 in-period adjustments model to calculate changes to price controls and the version of the model we use is published alongside this document.

Table 3: Summary of changes to the price controls for the PR19 blind year ODI revenue adjustments

Control		2020-21	2021-22	2022-23	2023-24	2024-25
Water resources (K factor)	PR19 final determination		3.37	3.25	2.65	1.60
	Revised		3.37	3.25	2.65	1.60
Water network plus (K factor)	PR19 final determination		-0.29	-0.27	-0.36	-0.23
	Revised		-0.03	-0.52	-0.36	-0.23
Wastewater network plus (K factor)	PR19 final determination					
	Revised					
Bioresources (sludge) - Revised total revenue (£m) – 2017-18 Nov CPIH prices	PR19 final determination					
	Revised					
Residential retail – Revised total revenue (£m) – nominal prices	PR19 final determination		19.361	19.573	19.788	19.997
	Revised		19.331	19.573	19.788	19.997

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

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 will adjust allowed revenue 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 will be made to the Bioresources price control. All wastewater ODI revenue adjustments will be applied to wastewater network plus.

2.4 Profiling of PR19 blind year adjustments

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 they would only relate to 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 set out that if, after reviewing our proposals, the company was of the view that there was a case for spreading the blind year adjustment across two or more years, it should include proposals in its response. In its response to the blind year draft proposals, South East Water specifically stated that it was happy for the ODI and RFI adjustments to be made as a single adjustment to 2021-22 revenue.

A1 Appendix 1 Reconciliation of PR14 incentives for 2015–20 for South East 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	-0.9	-0.5	-0.5				-0.1	-0.1	-0.1
Residential retail revenue	N/A	N/A	N/A				0.7	1.8	1.8
Wholesale revenue forecasting incentive mechanism	18.0	19.1	19.1				N/A	N/A	N/A
Totex	-4.9	-4.9	-4.9				N/A	N/A	N/A
Land sales	N/A	N/A	N/A				N/A	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	N/A				-0.5	0.0	-0.5
PR09 blind year adjustments	0.2	0.2	0.2				N/A	N/A	N/A
CIS RCV inflation correction	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
Other adjustments	0.0	0.0	0.0				N/A	N/A	N/A
Total	12.4	14.0	14.0				0.0	1.7	1.2
RCV									
Outcome delivery incentives	-0.4	-0.3	-0.3				N/A	N/A	N/A
Residential retail revenue	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
Totex	-17.9	-17.5	-17.5				N/A	N/A	N/A

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	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
Land sales	0.6	0.6	0.6				N/A	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	N/A				N/A	N/A	N/A
PR09 blind year adjustments	0.7	0.7	0.7				N/A	N/A	N/A
CIS RCV inflation correction	-24.4	-24.6	-24.4				N/A	N/A	N/A
Water trading	N/A	N/A	N/A				N/A	N/A	N/A
Other adjustments	0.0	0.0	0.0				N/A	N/A	N/A
2019-20 RPI-CPIH wedge RCV adjustments	N/A	N/A	0.3				N/A	N/A	N/A
Total	-41.5	-41.2	-40.7				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 'South East Water final determination' and in detail in 'South East Water – Accounting for past delivery final decisions'.

Revenue in these tables may not reconcile to the lines for 'Reconciliation of PR14 incentives, 2020-25' in table 4.12 in the 'South East 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 final blind year decisions 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	-0.3			0.0	-0.5			-0.1
Residential retail revenue	N/A	N/A			N/A	N/A			1.8
Wholesale revenue forecasting incentive mechanism	N/A	N/A			N/A	19.1			N/A
Totex	-0.9	-16.7			N/A	-4.9			N/A
Land sales	0.0	0.6			N/A	N/A			N/A
Residential retail service incentive mechanism	N/A	N/A			N/A	N/A			-0.5
PR09 blind year adjustments	0.0	0.7			N/A	0.2			N/A
CIS RCV inflation correction	-1.2	-23.2			N/A	N/A			N/A
Water trading	N/A	N/A			0.0	0.0			N/A
Other adjustments	0.0	0.0			N/A	0.0			N/A
2019-20 RPI-CPIH wedge RCV adjustments	0.0	0.3			N/A	N/A			N/A
Total	-2.0	-38.7			0.0	14.0			1.2

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	-2.0	-39.0		
IFRS adjustments	0.5	2.0		
2019-20 RPI-CPIH wedge RCV adjustments	0.0	0.3		
Midnight adjustments to RCV	-1.6	-36.7		

Note:
The IFRS16 adjustments are unaffected by 2019-20 inflation and out of scope of the blind year reconciliation. They remain unchanged from the 2019 final determination.
The 2019-20 RPI-CPIH wedge RCV adjustment reconciles the difference in the RPI-CPIH wedge that was forecast in the 2019 final determination RCV feeder model.

Table A1-4: Ofwat's view of the blind year adjustment for 2019-20 by PR19 price control for use in the revenue forecasting incentive model (£ million, 2017-18 FYA CPIH deflated: PR19 base year prices)

	Revenue adjustments			
	Water resources	Network plus water	Network plus wastewater	Bioresources
Wholesale revenue forecasting incentive mechanism	N/A	1.095		
Totex	N/A	0.055		
Water trading	0.000	0.000		
Other adjustments	N/A	0.000		
Total blind year adjustment (TBYA) for use in the RFI formula	0.000	1.150		

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533

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