Dŵr Cymru
Welsh Water

Linea
Fortran Road
St Mellons
Cardiff
CF3 0LT

Linea
Heol Fortran
Llaneirwg
Caerdydd
CF3 0LT

02920 740450
dwrcymru.com

Ofwat
Centre City Tower
Birmingham
B5 4UA

21 October 2021

By email only to: OfwatPandO@ofwat.gov.uk

Draft Determination of Dwr Cymru's in-period outcome delivery incentives for 2020-21

We welcome the opportunity to comment on the draft determination for the 2020-21 in-period Outcome Delivery incentives (ODIs). Our representations cover two main areas: tax and the treatment of the COVID-19 impacts.

Tax

The ODI in-period model includes a tax 'gross-up' adjustment to ensure that the company receives the level of ODI payments as envisaged in the Final Determination. To ensure that the ODI rates are in line with our Final Determination and Business Plan a 0% tax rate should be applied in the calculation of our in-period ODIs.

The model includes the tax adjustment to maintain the strength of incentives intended in the Final Determination. For those companies that have a corporation tax liability and received a corporation tax allowance in the Final Determination, any underperformance payments incurred would reduce the level of profit, and consequently the amount of corporation tax it pays, reducing the strength of the underperformance payments. Similarly, any outperformance payments will increase the company's profits and consequently the amount of corporation tax paid, reducing the size of the outperformance payments. The model applies a 'gross-up' tax adjustment to increase the size of the outperformance or underperformance payments to ensure the strength of the incentives is maintained.

However, our effective tax rate over the AMP is expected to be zero and this was reflected in our Final Determination and as a consequence we did not receive an allowance for corporation tax. This is because we have considerable capital allowances available throughout AMP7.

Our 2020-21 in-period determination includes net underperformance payments. The model currently grosses-up these penalties for a 19% corporation tax rate, in theory to offset a reduced corporation tax liability. However, as our effective marginal tax rate is zero, the application of the 19% effective rate artificially inflates the magnitude of the penalties envisaged in the Final Determination, because it aims to claw back a benefit that does not, in practice, arise. The tables below illustrate why it is appropriate to apply a company's effective tax rate in the in-period ODI model.

The first example shows where a company has taxable profits and therefore has an effective marginal tax rate of 19%. This shows that in order to maintain the strength of incentives as set out in the Final Determination it is appropriate to apply a tax adjustment of 19% to maintain the strength of the ODI incentives. Without the tax adjustment Company A's ODIs would have a been smaller than envisaged in the Final Determination (in the example £16.2m instead of £20m).

Company A: Effective Marginal Tax Rate 19%

		Base Case Company A	Company A- ODI Model 19% Tax Rate	Company A- ODI Model 0% Tax Rate
ODI Payments	£m		(20.0)	(20.0)
In-period ODI Model Effective Tax Rate	%		19%	0%
ODIs including Tax Adjustment	£m		(24.7)	(20.0)
Profit before Tax and ODIs	£m	100.0	100.0	100.0
ODI including tax	£m	0.0	(24.7)	(20.0)
Profit before Tax	£m	100.0	75.3	80.0
Effective Tax Rate	%	19%	19%	19%
Tax	£m	(19.0)	(14.5)	(15.2)
Profit After Tax	£m	81.0	61.0	64.8
Net ODI Paid	£m		(20.0)	(16.2)

The second table shows why in the case of Company B, which has an effective marginal tax rate of 0%, that applying a 19% tax adjustment to the in-period ODI determination increases the incentive rates beyond the level envisaged in the Final Determination. By applying a 19% tax rate in the model the incentive is significantly higher than intended (£24.7m rather than £20m).

Company B: Effective Marginal Tax Rate 0%

		Base Case Company B	Company B- ODI Model 19% Tax Rate	Company B- ODI Model 0% Tax Rate
ODI Payments	£m		(20.0)	(20.0)
In-period ODI Model Effective Tax Rate	%		19%	0%
ODIs including Tax Adjustment	£m		(24.7)	(20.0)
Profit before Tax and ODIs	£m	100.0	100.0	(100.0)
ODI including tax	£m		(24.7)	(20.0)
Profit before Tax	£m	100.0	75.3	80.0
Effective Tax Rate	%	0%	0%	0%
Tax	£m	0.0	0.0	0.0
Profit After Tax	£m	100.0	75.3	80.0
Net ODI Paid	£m		(24.7)	(20.0)

The examples show the impact for under-performance payments; however, the opposite is also true for outperformance payments. The application of a 19% marginal tax rate in the in-period ODI model for a company whose effective marginal tax rate is 0% will result in additional outperformance payments being charged to customers, above the level intended in the Final Determination.

The effective tax rate used in calculating allowed revenue for Dwr Cymru Welsh Water in the Final Determination was 0%. Our current and expected effective tax rate over the remaining of the AMP, as outlined in our Annual Performance Report, is also 0%. We would be happy to provide a tax calculation for 2022/23 to demonstrate this should it be required. To ensure that the strength of the incentives are as envisaged, the effective tax rate applied in the in-period ODI model should be changed to 0%.

Education activities

We can confirm that 5,834 individuals have participated in virtual interactive sessions with a company representative for more than 15 minutes.

In March 2020 schools were closed as a result of COVID-19. At the time there was a significant amount of uncertainty with regards to schools opening. Our approach was to employ a number of different tools to provide educational material, including materials that could be used for home schooling. The draft determination only recognises interactive session as counting towards the performance commitment level. Whilst we agree that interactive sessions work best, the approach taken by Ofwat in the draft determination values at zero the benefit of the additional educational material that was developed and provided by us and used extensively during the pandemic. We believe that in these circumstances this should be recognised as counting towards the performance level, even if perhaps in a way that recognises the lesser value compared to interactive sessions.

We propose that the measure is reviewed at the end of the AMP to consider the performance in the round. This approach maintains the incentives to outperform the stretching performance commitment whilst also allowing a decision to made in the round with regards to the additional educational material developed during the pandemic.

Visitors Centres

Our in-period determination requested adjustments to the in-period ODIs for visitor’s centres due to factors beyond management control. Access to our visitors’ centres in 2020-21 was severely restricted due to Government restrictions as a result of COVID-19. We put in place a number of measures to ensure that we could open our centres in a safe manner.

The draft determination outlines that there is uncertainty with regards to the level of demand of our visitors’ centres in the future. We agree that there is uncertainty, which can be both positive and negative due to changes in consumer demand for domestic and overseas holidays.

Our performance commitment level for this measure is stretching and significant outperformance will be needed to offset the large underperformance payment as a result of COVID-19. We propose that the measure is reviewed at the end of the AMP so performance can be considered in the round. This approach maintains the incentives to outperform but does not penalise for factors beyond management control.

Yours faithfully

[redacted]

Eleri Rees
Strategy and Regulation Director