



# Thames Water Response to Ofwat in-period Draft Determination for 2020-21

October 2021

## 1. Summary

- 1.1. This document provides Thames Water's response to Ofwat's in-period draft determination for 2020-21.
- 1.2. We welcome Ofwat's intervention to change the timing of payments for the PCC ODI to end of period. We provided detailed views in our response to the PCC consultation in July, and we encourage Ofwat to consider our proposals.
- 1.3. We agree with Ofwat's decision to include an underperformance payment of £5.365m (2017-18 prices) to correct for an overstatement of performance on the company's asset health performance commitment from the 2014 price review (PR14), in line with our response (dated 2 Aug 2021) to the Ofwat query on decommissioned mains as part of our AMP6 Asset Health Performance Commitment.
- 1.4. We have found that the C-Mex and D-Mex models have applied nominal and real prices inconsistently. We think this is a technical error that requires correction to rebase the output from nominal prices to real prices before feeding into the In-Period Adjustment Model. We articulate the findings and demonstrate our workings for the correction in Section 2. We have applied rebased C-Mex and D-Mex payments in our response to Ofwat's in-period draft determination.

## 2. Issues in C-Mex & D-Mex calculation

- 2.1. In the C-Mex model, ODI payments are calculated using the 2020-21 residential retail revenue allowance from the PR19 Final Determination (FD) in nominal prices, but the results are treated as being in 2017-18 prices without any price base conversion (see rows 8 and 11 in Figure 1: C-Mex model).

Figure 1: C-Mex model

	A	B	C	D	E	F	G
1	<b>Performance payments</b>					<b>2020-21</b>	
2						Constant	Unit
3	Companies' C-MeX payments						
4							
5	Company names					Text	
6	C-MeX score					Number	
7							
8	Allowed residential retail for year of performance					£m (nominal)	
9	Company's standard performance payment rate					Percentage	
10	Company's higher performance rate					Percentage	
11	Standard performance payments					£m (2017-18 FYA CPIH prices)	

2.2. Similarly, in the D-Mex model, ODI payments are calculated using 2020-21 Developer Services actual revenues in nominal prices, but the results are treated as being in 2017-18 prices without any price base conversion (see rows 8, 10, 12, and 14 in Figure 2: D-Mex model).

Figure 2: D-Mex model

	A	B	C	D	E	F	G
1	<b>Performance payments</b>					<b>2020-21</b>	
2						Constant	Unit
3	Companies' D-MeX payments						
4							
5	Company names					Text	
6	D-MeX score					Number	
7							
8	Developer services revenue - water					£m (nominal)	
9	Company's performance payment rate					Percentage	
10	Performance payments - water					£m (2017-18 FYA CPIH prices)	
11							
12	Developer services revenue - wastewater					£m (nominal)	
13	Company's performance payment rate					Percentage	
14	Performance payments - wastewater					£m (2017-18 FYA CPIH prices)	

2.3. We acknowledge that the PR19 reconciliation rulebook mentions 'no inflation adjustment is necessary' for the C-Mex and D-Mex models, but we think that treating financial values in nominal prices as being in real prices is a technical error. The consequence of this approach is that the calculation of the reward and penalty is inconsistent with the FD. For example, the FD set out the range of the reward and penalty for C-Mex as a percentage of allowed retail revenue, setting the maximum penalty at 12% of annual allowed revenue.<sup>1</sup> The approach used to calculate the C-Mex and D-Mex payments results in rewards and penalties that exceed the stated percentages for the company that is highest ranked and for the company that is lowest ranked<sup>2</sup>. We therefore recommend that Ofwat revisit the indexation treatment in the C-Mex and D-Mex models to bring it in line with the FD.

2.4. In line with the indexation treatment in the In-Period Adjustment Model<sup>3</sup>, we have rebased C-Mex and D-Mex payments from nominal price bases to 2017-18 prices in our response (see Table 1) using November CPIH values from the previous year (see Table 2).

<sup>1</sup> "Those companies that score above the median company score will receive standard outperformance payments for that year of up to 6% of that year's annual allowed residential retail revenue and those that score below the median company score will incur underperformance payments of up to 12%." (PR19 final determinations – Customer measure of experience (C-MeX) and developer services measure of experience (D-MeX) policy appendix.)

<sup>2</sup> The 2020-21 C-MeX penalty rate for Thames Water in nominal prices (£17.76m, inflated from £16.659m in 2017-18 prices) is 12.8% of the allowed revenue (£138.82m) as per the Ofwat draft determination.

<sup>3</sup> The 2020-21 In-Period Adjustment Model takes ODI payment in 2017-18 prices then inflates them to 2022-23 prices using November CPIH values from the previous year.

Table 1: C-Mex and D-Mex price base conversion

2020-21 ODI payment	Price base	Ofwat draft determination (£m)	Thames Water response (£m)	Difference (£m)
C-Mex payment	Nominal	-16.659	-16.659	0.000
	2017-18	-16.659	-15.630	1.029
D-Mex payment	Nominal	-1.861	-1.861	0.000
	2017-18	-1.861	-1.746	0.115

Table 2: Indexation applied for price base conversion

	Value	Source
CPIH November 2016	101.8	Ofwat DD In-Period Adjustment model, tab InpExpected, cell K85
CPIH November 2019	108.5	Ofwat DD In-Period Adjustment model, tab InpExpected, cell N85

2.5. The 2020-21 residential retail revenue allowance from the PR19 FD is based on forecast numbers of customers, so we expect that the residential retail revenue allowance will be adjusted to use the actual number of customers (see Table 3). We have not incorporated any such adjustment in our response but seek Ofwat's clarification regarding whether the C-Mex payment should be derived using the actual residential retail revenue allowance.

Table 3: Forecast and actual number of residential customers

	2020-21 forecast in PR19 FD	2020-21 actual	Difference
Number of residential customers	5,573,043	5,586,598	13,555
Source	Notification of the final determination of price controls for Thames Water, p.14	Thames Water Annual Performance Report 2020-21, table 2F, line 7	

2.6. We note that the value that Ofwat have used for the residential retail revenue allowance from the PR19 financial model is from the item labelled “Residential retail service revenue (sum of margin, CTS and revenue adjustment) – nominal” (£138.8m), instead of the item labelled “Residential retail service revenue (sum of margin, margin on DPC, CTS and revenue adjustment) – nominal” (£139.6m).

### 3. Other comments

3.1. We regret that Ofwat did not accept our proposal to reprofile the Renewable Energy Generated performance commitment target, missing an opportunity to set a more stretching renewable energy target with responsive and flexible regulation, at no extra cost to our customers.

3.2. We reported a forecast number of WINEP schemes to be delivered by September 2021 as 182 in our 2020-21 annual performance report. Our actual number of WINEP schemes delivered by September 2021 post audit is 187. This has no impact on ODI payments. The final number of 187 completed schemes is still subject to final approval by the Environment Agency, which they have delayed until November 2021, but no changes are anticipated due to the takeover controls, assurance, and external validation mechanisms already in place. Each of the Year 1 schemes is supported by a signed benefits delivery form and, wherever possible, external validation, such as sample testing results and independent inspection reports. Internal audit have assessed the revised number of 187, conducting an overall process and risk review, along with sampling 20 of the schemes (10%) for evidence of completion. The revised number has been fully signed off at every level from information provider through to Executive level.

3.3. We note that the inflation forecast for November 2021 CPIH currently being used by Ofwat is 2.93% and that this will be revised for the final in-period determinations. We would expect that the forecast ultimately used by Ofwat will be materially higher than this initial figure given our current internal estimates of the November CPIH index. As published in our Statement of Significant Change 2022-23 for Indicative Wholesale Charges<sup>4</sup>, our current view is that the year-on-year increase will be in the region of 3.3%.

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<sup>4</sup> [“Statement of significant change 2022-23 indicative wholesale charges”](#), Thames Water, October 2021

