South Staffs Water

South Staffs Water PR14 Reconciliations

Update - July 2019

making water count

1. Introduction

This document provides an update to South Staffs proposed reconciliation adjustments for the 2015-20 period, setting out how the Company has performed in 2018-19 and its forecast for 2019-20.

As set out in Ofwat's e-mail of 3 May, we have excluded SIM and the blind year 2010-15 reconciliations.

In summary, the value of the PR14 adjustments as set out in the submitted feeder models in 2017-18 CPIH prices are set out below along with the movement from our business plan submission:

	July-19 submission		Sept-18 submission		Movement	
17-18 CPIH prices	**RCV £m**	**Revenue £m**	**RCV £m**	**Revenue £m**	**RCV £m**	**Revenue £m**
WRFIM (excluding developer contributions, including AMP 5 RCM)		(2.057)		(1.883)	0.000	(0.174)
Totex	0.657	0.069	(0.148)	(0.362)	0.805	0.431
Residential retail		1.196		1.002	0.000	0.194
ODIs		2.571		3.352	0.000	(0.781)
Land sales	(0.063)		(0.063)		(0.000)	0.000
Total	**0.593**	**1.779**	**(0.211)**	**2.109**	**0.804**	**(0.330)**

Inflation figures in both the data tables and the feeder models have been updated for 2018-19 actuals. The inflation assumption for 2019-20 of 3.0% for RPI and 2.1% for CPIH are unchanged from our previous submission.

2. Assurance

In line with our overall PR19 assurance framework, we have used a three line approach to assure the information being submitted:

Reviewer	Work undertaken
Executive Team Member review	Overall check that the tables are in line with expectation based on performance to date and the latest budgets.
Independent internal assurance	Detailed tick and tie of information to source and that numbers are consistent between tables and models. Appendix A1 includes the assurance report provided by independent internal audit.
Jacobs UK Limited	Assurance that the tables and models have been completed in line with the guidance and noting any exceptions (see below). Appendix A2 includes the assurance report provided by Jacobs.

In addition, a draft of this narrative was approved at a Board meeting on 27 June 2019.

3. Wholesale total expenditure (totex) sharing

The Company has completed the reconciliation model for wholesale totex and a summary is set out below:

		2015-16	2016-17	2017-18	2018-19	2019-20	AMP 7
Allowed Totex from final menu	12-13 prices	76.780	77.514	77.804	77.947	76.889	386.933
Actual totex	12-13 prices	72.573	76.024	81.931	80.835	77.770	389.135
Annual Variance		-4.207	-1.489	4.127	2.889	0.882	2.201
Cumulative variance		-4.207	-5.696	-1.569	1.319	2.201	
Financing adjustment		-0.639	-0.167	0.302	0.104	0.000	
Total annual variance (inc financing adjustments)	12-13 prices	-4.846	-1.656	4.429	2.993	0.882	**1.802**
PAYG rate							**68.2%**
Revenue adjustment	17-18 CPIH prices						**0.069**
RCV adjustment	17-18 CPIH prices						**0.657**

Actual totex in 2018-19

The Company's totex of £80.8m (2012/13 prices) was £2.9m (3.7%) higher than allowed in price limits for 2018-19.

Actual wholesale operating costs per the regulatory accounts in 2018/19 are £0.4m higher than the fast money from the Final Determination (FD). In the FD, Ofwat adjusted the split of expenditure between fast money and slow money to smooth bills. In 2018/19 this resulted in the transfer of £2.0m from fast money to slow money. IRE (which is included in both operating expenditure in the regulatory accounts and fast money in the FD) was £2.7m lower than the FD in 2018/19 following a decision to move some expenditure from infrastructure renewals to capital expenditure over the AMP period while maintaining the total level of expenditure across these two areas. As a result, wholesale capital expenditure was £2.3m over the FD reversing the underspend in prior periods of the AMP, with the cumulative overspend to be managed to a flat position in line with the Final Determination by the end of the AMP. The remaining £1.1m overspend in operating costs was as a result of additional costs incurred from the hot dry summer of 2018 which increased production costs.

Actual totex for the four years to 2018-19

The cumulative position for the four years to 2018/19 shows totex £1.3m (0.4%) above the FD with operating costs being £10.9m lower than the FD.

Ofwat adjusted the Pay As You Go (PAYG) rate in the FD to smooth bills in the period to 2020. The impact was to have an FD PAYG rate of 73.9% in 2015/16 compared to the average in the FD of 68.2%, which was in line with the expected allocation between capital and operating expenditure. This smoothing accelerated £4.6m of fast money into the FD for 2015/16 year from slow money and adjusted subsequent years as an offset. The cumulative position for the four years to 2018/19 is an acceleration of

£2.3m. IRE was £10.8m lower than the FD, offset by an overspend on capital expenditure of £12.1m. The remaining £2.4m overspend in operating costs was predominantly related to the additional costs of the 2018 summer and ongoing upward pressure on power costs driven by higher pass through charge rates partly offset by the Laboratory and Cumulo rates benefits discussed above.

Forecast totex for 2019-20

Totex for the remaining year of the price control is forecast to be broadly in line with that assumed in our Business Plan submission. This takes the five year position to £2.2m above the FD, reflecting the actual overspend in operating costs for the first four years outlined above. The overspend of £1.3m of capital investment and infrastructure renewals expenditure is expected to reverse in 2019-20.

4. Wholesale revenue forecasting incentive mechanism (WRFIM)

The Company has completed the reconciliation model for WRFIM and a summary is set out below

£ms	2015-16	2016-17	2017-18	2018-19	2019-20	AMP 7
Wholesale revenue allowed per Final Determination	101.991	102.185	103.968	106.265	109.060	523.469
Under recovery from two years previously (before financing adjustments)			(0.200)	0.886	(0.190)	
Adjusted wholesale allowed revenue	101.991	102.185	103.768	107.151	108.870	523.469
Actual revenue recovered	102.191	101.300	103.958	107.150	108.841	523.439
Under/(over) recovery	(0.200)	0.886	(0.190)	0.001	0.029	0.030
Under recovery to be applied to AMP7 (including financing costs and inflation in outturn prices)						**0.109**
AMP5 RCM adjustment to be applied at PR19 (Outturn price base)						**-2.199**
Total Under recovery to be applied to AMP7 (17-18 CPIH prices)						**-2.057**

This table excludes the variance on developer contributions which has been dealt with via a separate claim. An update to this claim is set out in section 5.

Actual WRFIM position excluding developer contributions for the four years to 2017/18

In 2015-16, wholesale revenues were very close to those allowed, being £0.2m (or 0.2%) higher. This over recovery was deducted from the allowed revenue in 2017-18 when setting charges.

In 2016-17, wholesale revenues were £0.9m lower than allowed due to lower than expected demand from metered customers with the summer of 2016 being cooler than normal. This variance was still only 0.9% of the allowed revenue and within the penalty threshold of 2%. This under recovery was included in the allowed revenue in 2018-19.

After adjusting for the WRFIM over recovery of £0.2m from 2015-16, wholesale revenues in 2017-18 were only £0.2m higher (0.22%), predominantly driven by higher business customer demand.

After adjusting for the WRFIM under recovery of £0.9m from 2016-17, wholesale revenue in 2018-19 was in line with that allowed.

Forecast WRFIM position excluding developer contributions for 2019-20

The wholesale revenue for 2019-20 after updating the forecast November 2018 RPI of 3.4% with the actual November RPI of 3.2% is broadly in line with that assumed in our Business Plan submission. This is expected to bring the five year position within 0.01% of that allowed.

5. Developer contributions claim

Executive summary

A summary of the variances to the Final Determination for the five years is set out below:

Summary of variances - Outturn Prices		2015-16	2016-17	2017-18	2018-19	2019-20	5 year Total
Variance in connection charges due to number of connections undertaken by the Company	£m	0.609	0.440	1.532	1.281	1.172	5.035
Variance in the unit price per connection	£m	1.368	1.776	1.082	0.670	1.283	6.178
Variance in infrastructure charges	£m	0.230	0.163	0.931	0.000	0.000	1.324
Variance in mains requisitions due to increase in volume and not included in revenue	£m	0.679	1.746	0.668	1.351	1.111	5.556
Total Variance as reported in APR	**£m**	**2.886**	**4.125**	**4.214**	**3.302**	**3.566**	**18.092**

The total variance has fallen from £18.9m in our business plan submission to £18.1m.

The over recovery of developer contributions in 2018-19 (ignoring the £0.3m over recovery of infrastructure charges recovered through the new developer charging rules) was £3.3m compared to a forecast in our business plan of £3.8m. This is as a result of a lower unit cost of connection than the historic three year average we used in our submission.

The 2019-20 position has been updated to reflect the new four-year average connection cost reducing the over recovery from £3.9m to £3.6m.

Details on the actual 2018-19 position and the revised forecast for 2019-20 are set out in the rest if this section.

2018-19 variance due to the number of connections

There were 3,869 new connections undertaken by the Company during the year which was 295 (8%) higher that assumed in our business plan submission.

Compared to the PR14 Final Determination the absolute number of new properties built was higher with the proportion of connections undertaken by Self Lay Organisations (SLOs) being lower than was assumed in the Business Plan. This is set out below:

2018-19	Unit	Final Determination	Actual	Variance
Number of connections	#	4.324	5.581	1.257
Number of connections by the Company (i.e not self-lay)	#	1.116	3.869	2.753
Proportion of connections done by Company	%	25.8%	69.3%	43.5%
Contribution per connection in Company Business Plan (Outturn prices)	£			£465
Variance in connection charges due to number of connections undertaken by the Company (Outturn Prices)	£m			1.281

2018-19 variance due to the type of the connection

The actual mix of work for 2018-19 included more standard connections than we had seen in the previous three years which has resulted in a lower variance than assumed in our Business Plan submission as set out below:

2018-19	Unit	Final Determination	Actual	Variance
Number of connections	#	4.324	5.581	1.257
Number of connections by the Company (i.e not self-lay)	#	1.116	3.869	2.753
Proportion of connections done by Company	%	25.8%	69.3%	43.5%
Average contribution per connection (Outturn prices)	£	£465	£638	£173
Variance in connection charges due to unit price of connections undertaken by the Company Outturn prices)	£m			0.670

2018-19 variance in infrastructure charges

As the infrastructure charge is a fixed charge per property for domestic connections and a multiple of the charge for non-household properties with connections greater than 32mm, the level recovered is directly linked to the number of properties connected in the year.

The Company has experienced a higher number of connections in 2018-19 compared to the Final Determination and hence recovered £0.285m more infrastructure charges. This is summarised below:

2018-19	Unit	Final Determination	Actual	Variance
Number of connections	#	4.324	5.581	1.257
Standard Infrastructure charge (*outturn prices*)	£	£377	£325	-£52
Infrastructure charge receipts *(Outturn prices)*	£m	1.628	1.914	0.285

Note: The actual infrastructure charge receipts do not equate to the number of connections multiplied by the unit charge due to infrastructure credits.

From 2018-19, infrastructure charges are reconciled as part of the new developer charging rules and companies are required to balance their costs with revenues received, as far as is reasonably possible over a rolling 5-year cumulative period. We have therefore excluded this over recovery from WRFIM and the claim for 2018-19. This also applies for 2019-20 (a forecast under recovery of £0.024m).

2018-19 variance on mains requisitions

The assumed level of mains requisition charges included in the net totex was £0.533m (2012-13 prices) which in outturn prices is set out below:

Outturn prices	Unit	2015-16	2016-17	2017-18	2018-19
Mains Requsitions included in the FD but excluded from Table W3 (Outturn Prices)	£m	0.587	0.599	0.622	0.641

These contributions were not included in the relevant PR14 business plan tables due to how the guidance was interpreted and therefore, a sum equal to mains requisition charges is not included in the Company's final allowed Wholesale revenues.

For 2018-19, this has generated a difference to the Wholesale allowed revenue as follows:

2018-19	Unit	Final Determination	Actual	Variance
Contributions received from mains requisitioning charges (*Outturn Prices)*	£m	0	1.351	1.351

As this additional developer income results from increased cost that has again been legitimately incurred, it is proposed that all mains requisition charges recovered from developers is allowed by Ofwat.

2019-20 forecast years

The Company has reforecast the level of developer contributions for 2019-20 and this is set out below:

Number of connections

This forecast of Company connections has used the four year historic average. This has then been grossed up using the three year average % of Company connections to arrive at a total number of connections including self lay. This is set out below:

	2015-16	2016-17	2017-18	2018-19	Four year average
No of connections by the Company	2.904	2.364	4.637	3.869	3.444
average % undertaken by the Company	69.5%	55.5%	67.3%	69.3%	65.4%
Forecast number of total connections					5.264

Forecast costs

As mentioned above, infrastructure charges are reconciled as part of the new developer charging rules and companies are required to balance their costs with revenues received, as far as is reasonably possible over a rolling 5-year cumulative period. Therefore any variance projected for 2019-20 has been excluded.

The connection charge is calculated as the average unit connection charge seen in the first four years of the period. This is set out below:

£s	2015-16	2016-17	2017-18	2018-19	Average
Average unit connection cost	£897	£1,186	£685	£638	£852

The average connection cost of £852 is £71 lower than that assumed in our business plan submission as a result of the lower actual cost in 2018-19.

This average unit cost is multiplied by the number of Company connections of 3,444 to give a total cost and hence contribution of £2.933m.

The forecast for mains requisitions is calculated as the four year average of contributions received in the period as shown below:

£m	2015-16	2016-17	2017-18	2018-19	Average
Mains requistions contributions	0.679	1.746	0.668	1.351	1.111

Overall, for 2019-20, the reforecast contributions are:

£m	2019-20
Connection charges	2.933
Infrastructure charges	1.711
Mains requisitions contributions	1.111
Total developer contributions	**5.755**

*Infrastructure charges included for consistency and completeness with table WS13, line 23.

6. Residential retail

The Company has completed the reconciliation model for residential retail and a summary is set out below.

£ms	2015-16	2016-17	2017-18	2018-19	2019-20	AMP 7
Expected retail revenue	14.938	15.156	15.794	16.764	17.269	79.920
Actual / forecast retail revenue	14.934	14.679	15.218	16.567	17.269	78.666
Under/(over) recovery	0.004	0.477	0.576	0.197	0.000	1.254

Overall, residential retail revenue for the five year period is forecast to be within 1.6% of expectation.

Actual customer numbers for the four years to 2018-19

The actual number of customers for the first three years of the period has been marginally above that assumed at PR14 being 5,006 (0.8%) higher in 2015-16 2,040 (0.3%) higher in 2016-17 8,709 (1.3%) higher in 2017-18 and 12,589 (1.9%) in 2018-19.

Part of the driver for the higher number of customers is a reduction in void properties in the South Staffs region. The Company has also seen new connections above that assumed in the PR14 Final Determination (4,667 additional for the first four years of the period).

Actual retail revenues compared to expectation for the four years to 2018-19

In 2015-16, the overall difference between actual revenue compared to that expected from the actual customer numbers was small, being £0.004m higher.

In 2016-17 and 2017-18, there was a £0.477m (3.0%) and £0.576m (3.7%) shortfall in revenue respectively driven by lower demand from metered customers with the summer of 2016 and 2017 being cooler than normal.

In 2018-19, there was a further small under recovery of £0.197m (1.2%).

Forecast retail revenues compared to expectation for 2019-20

Consistent with our Business Plan submission, the retail revenues for 2019-20 are expected to be in line the Final Determination with charges being set to recover the allowed retail revenue.

For 2019-20, we have updated the customer numbers to be consistent with the projections used when setting our charges. We have also considered whether we should update these projections based on the actual customers numbers to be reported in the 2018-19 APR. We have concluded that the number of customers forecast when we set charges are still our best estimate based on our expectation of meter optants, new connections and void properties for the year.

ODIs

ODI performance for the first four years of the price review period is set out in our Annual performance Report which can be found at the link below:

https://www.south-staffs-water.co.uk/publications/annual-reports

The true up on ODIs is set out below showing rewards or penalties for the first four years of the period and forecast rewards for the final year:

2019-20 forecast

The expectation is that a maximum reward is achieved in 2019-20 for supply interruptions and that all other performance commitments in that period neither earn a reward nor incur a penalty.

For the first two years of the period (2015-16 and 2016-17), maximum rewards were achieved for supply interruptions and 2018-19 was very close to maximum. 2017-18 performance is considered an exception as it was impacted by a small number of events through the year (although a reward was still earned). It is therefore expected that maximum rewards will be achieved in the final year of the period.

We have reviewed our forecasts for Mean Zonal Compliance (MZC) and acceptability of water to customers based on our performance for the six months to the end of June 2019.

At the half way point of the calendar year we have had one MZC failure and we are presently on track to achieve 99.99% compliance. We are working hard to ensure that performance does not deteriorate to the level at which a penalty is incurred, at 99.95% compliance.

For acceptability of water to customers we are pleased to be on target for achieving our 1.23 performance commitment at the half year position. Last year we experienced a step up in customer contact during the summer peak demand period and we are actively working to manage this. At the moment we have not experienced a recurrence of this step change, which was driven by the substantially increased flow rates caused by increased demands during the hot spell last summer.

Appendix A1

SOUTH STAFFORDSHIRE PLC – INTERNAL AUDIT

Subject Matter: PR14 Reconciliations

Group Internal Audit was requested to carry out an independent review of information contained within the PR14 Reconciliation statements being submitted to Ofwat.

This review entailed checking the inputs to supporting documentation and obtaining explanations behind the numbers reported. Figures from the feeder models were then checked through to the summary of PR14 adjustments.

From work undertaken Internal Audit is satisfied that the figures being reported are in line with supporting internal documentation.

Glyn Palmer BA (Hons) FCA
Group Internal Audit Manager
July 2019

Appendix A2

SSC annual audits

South Staffordshire Water

PR19 Reconciling for past performance assurance report – APR update

12 July 2019

Final

SSC annual audits

Project No:	B2339300
Document Title:	PR19 Reconciling for past performance assurance report – APR update
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Client Name:	South Staffs Water
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1. Introduction

Ofwat requires companies to publish an Annual Performance Report (APR) each July. The APRs are an important element of Ofwat's framework for encouraging companies to be transparent about their performance and for collecting information it requires to perform its duties. They also allow stakeholders to hold companies to account when they do not deliver against their promises. It is therefore important that customers and other stakeholders can have trust and confidence in the information contained in companies' APRs.

As your technical assurance partner, and in line with the approach to assurance you set out in your PR14 business plan and 2018 assurance plan, you asked us to take a risk-based approach to reviewing the following aspects of your 2018-19 APR reporting:

- **Performance commitments (PCs)** – the proposed performance figures for the PCs in your final determination (FD) that have financial rewards and penalties associated with them and your reputational per capita consumption (PCC) PC;
- **Common PCs** – your reporting across each of the eight common PCs Ofwat requires water only companies to shadow report in the APR, focusing on the compliance assessments you are required to make;
- **APR section 4 tables and lines** – a selection of the non-financial lines in APR section 4 tables 4A, 4P and 4Q, focusing mainly on sample checking across the lines you asked us to review;
- **Return on Regulated Equity (RoRE) and financial flows** – your notional RoRE figure and calculations and your interpretation of Ofwat's financial flows methodologies (now that reporting is part of the APR);
- **Long-term viability statement (LTVS)** – your LTVS for consistency with Ofwat guidance (including IN 19/07 that clarified Ofwat's LTVS requirements); and
- **Reconciling for past performance –** the value of any movements in the PR14 adjustments compared to your PR19 business plan submission to reflect 2018-19 performance and updated forecasts for 2019-20, as Ofwat asked companies to update their proposed reconciliation adjustments for the 2015-20 period through the 2018-19 APR (our work therefore built on the assurance we provided on your business plan in this area).

The conclusions drawn from our work to date across these areas are summarised in our APR19 Assurance letter (dated 2 July 2019). This letter is supported by separate detailed reports covering the areas noted above. This report relates to the last area listed above. We are providing three other separate reports that cover the other areas.

2. Background

Part of the 2019 price review (PR19) is the calculation of adjustments to take account of 2015-20 performance and incentive mechanisms.

Ofwat has produced the PR14 reconciliation rulebook which describes the way that it will reconcile companies' 2015-20 performance against the PR14 final determinations at PR19, through the following mechanisms:

- outcome delivery incentives (ODIs), which provide companies with rewards for achieving stretching performance targets and compensate customers if performance is below performance targets;
- wholesale total expenditure (totex) sharing, where company over- and underperformance is shared with customers;

- wholesale revenue forecasting incentive mechanism (WRFIM), which provides financial incentives for companies to provide accurate forecasts, and ensures under- and over-recovery is reconciled;
- PR09 reconciliation (blind year adjustments); and
- household retail, where the total revenue allowance is adjusted for actual customer numbers.

Given the potential materiality of the adjustments, and the fact that the way adjustments are calculated can be complex and open to different possible interpretations, you engaged us to conduct a risk based review in September 2018 of your initial business plan submissions relating to the Reconciliation Rule Book – Feeder Models. Our assurance focused on your interpretation of the guidance for the PR14 reconciliation rulebook and subsequent application via the feeder models.

At that time, we considered that overall, for the Reconciliation Rule Book – Feeder Models:

- your team had a good understanding of the data required to populate the feeder models, in line where appropriate with other PR19 tables;
- your team had a good understanding of your processes required to populate the feeder models, in line with Ofwat guidance; and,
- your team had a good understanding of how the outputs of the feeder models provided data required for the financial model and any relevant PR19 tables.

3. APR19 update

Ofwat requires each company to provide an update to their proposed reconciliation adjustments for the 2015-20 period, setting out how it has performed in 2018-19 and its forecast for 2019-20. It has asked companies to provide the update with their 2018-19 APR submissions – though in line with an Ofwat e-mail of 3 May, you have excluded SIM and the blind year 2010-15 reconciliations from your update.

Consistent with our scope, we reviewed the value of any movements in the PR14 adjustments compared to your PR19 business plan submission. You provided your final data on 11 July 2019, which is summarised in table 1 below.

Table1 Movements in reconciliation adjustments

	July-19 submission		Sept-18 submission		Movement	
	RCV	Revenue	RCV	Revenue	RCV	Revenue
17-18 CPIH prices	£m	£m	£m	£m	£m	£m
WRFIM (excluding developer contributions, including AMP 5 RCM)		(2.057)		(1.883)	0.000	(0.174)
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Total	**0.593**	**1.779**	**(0.211)**	**2.109**	**0.804**	**(0.330)**

4. Conclusion

Your team has continued to demonstrate that it is committed to owning this process and appears to have fully considered the impact of the latest information (eg: the impact of 2018-19 actuals on the proposed reconciliation adjustments for the 2015-20 period).

You have confirmed that you will provide commentary for this table that supports the changes from your initial September 2018 PR19 business plan submission to this APR update.