

April 2014

# Setting price controls for 2015-20 – draft price control determination notice



**OFWAT**

## Overview

### Overview of draft determinations for the two enhanced companies

**This document sets out our draft determinations of price controls for the two enhanced companies, South West Water and Affinity Water, for the five years from 1 April 2015.**

In ‘[Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans](#)’ (our ‘final methodology statement’), we said that we would deliver a proportionate price setting process and put an assessment of the quality of companies’ business plans at the heart of this price review. We wanted companies to take increased ownership of their plans and focus on customers.

On 4 April 2014, we awarded enhanced status to the business plans of South West Water and Affinity Water following the completion of our risk-based review. While all companies had delivered business plans which showed a step change in focus and approach, these two companies produced high-quality business plans that stood apart from the other companies.

We confirmed that one of the benefits of enhanced status would be that those companies would fast-track through the price review process – benefitting them, their customers and investors by giving significantly greater clarity and certainty, and enabling them to begin to deliver their business plans now. Therefore, we are publishing the draft determinations for South West Water and Affinity Water in line with our proportionate price setting process and in recognition of the high quality of the business plans put forward by these companies.

For the first time, these draft determinations also include separate price controls for retail and wholesale water and wastewater activities, which allow us to target our price control regulation better and support and facilitate the development of the proposed competitive market for retail services to non-household customers in England.

We have developed these draft determinations in accordance with our final methodology statement and our statutory duties. We have also had regard to relevant guidance from the UK Government and the principles of best regulatory practice to be transparent, accountable, proportionate, consistent and targeted.

We invite comments on these draft determinations by **4 June 2014**. Unless otherwise stated, all values in this document are in 2012-13 prices.

## Summary of the enhanced company draft determinations

**Both companies provide for: reduced bills relative to inflation, better services and meeting their statutory obligations in the next control period.**

Our draft determinations reflect the companies' updated business plans, which are in line with what we set out in '[Setting price controls for 2015-20 – risk and reward guidance](#)' (our 'risk and reward guidance').

In our final methodology statement, we said that the plans of enhanced companies would be accepted in the round and substantially unchanged for draft determinations. We also said that this does not rule out some adjustments being required to retain alignment with the industry framework of price limits, relevant for all customers and companies. Consequently, the draft determinations also reflect our current view of industry-wide assumptions which we will make for all companies, such as calculating an industry average cost to serve (ACTS) and the service incentive mechanism (SIM).

The technical appendix that accompanies this document sets out some specific elements of our general methodology relevant to the development of these draft determinations.

### Average household customer bills

Table 1 sets out the impact of our draft determinations for South West Water and Affinity Water on average household customer bills over the period 2015-20. By 2019-20, **overall bills for directly-provided regulated services will fall by around 7% and 11%** in real terms for South West Water and Affinity Water respectively, relative to average bills in 2014-15. The profile of bills for each company reflects the profiles they proposed in their revised business plans.

**Table 1 Summary of average household customer bills<sup>1,2</sup> (2012-13 prices)**

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Customer bill – South West <sup>3</sup>	516	492	488	485	482	479
Customer bill – Affinity <sup>4</sup>	174	165	165	159	156	155

**Notes:**

1. Customer bills for our draft determination are based on an implied menu choice.
2. We use average household bills to provide a broad indication of the movement that customers will see, but the actual bill will depend on an individual customer's specific circumstances.
3. Average bill for South West Water is for water and sewerage customers and does not reflect the £50 Government contribution.
4. Water only customers. Affinity Water bills are the unweighted average of the three previous companies in the last price control period.

**Outcomes for customers**

The outcomes in the draft determinations reflect the respective priorities and commitments that South West Water and Affinity Water developed in consultation with their own customers. We summarise the outcomes for both companies in tables 2 and 3 below. We set out full details of each company's performance commitments in the company-specific appendices that accompany this document.

In this area particularly, we recognise that the essential work of the customer challenge groups (CCGs) has ensured that the plans for both South West Water and Affinity Water reflect customers' priorities.

**Table 2 Summary of South West Water’s outcomes**

Wholesale water	Wholesale wastewater	Retail
<b>Clean, safe and reliable supply of drinking water</b> – including reducing how often customers have to contact the company about the taste and smell of drinking water.	<b>Reliable wastewater service</b> – including reducing the number of internal and external flooding incidents as a result of overloaded sewers.	<b>Responsive to customers</b> – including delivering an improvement in customer satisfaction and value for money.
<b>Available and sufficient water resources</b> – including reducing the time taken to fix significant leaks.	<b>Responsive to customers</b> – increasing the percentage of operational wastewater customer contacts that are resolved first time.	<b>Fair charging</b> – including increasing the number of customers assisted by water poverty initiatives.
<b>Resilience in extreme conditions</b> – including avoiding the interruption of drinking water supplies as a result of flooded company sites.	<b>Protecting the environment</b> – including reducing pollution incidents from company wastewater assets.	
<b>Responsive to customers</b> – increasing the percentage of operational water customer contacts that are resolved first time.	<b>Benefiting the community</b> – including improving river and bathing water quality.	
<b>Protecting the environment</b> – including increasing the scale of the company’s catchment management activities to improve water quality.		
<b>Fair charging</b> – including increasing the percentage of water customers paying a metered bill.		

**Table 3 Summary of Affinity Water’s outcomes**

Wholesale water	Retail
<p><b>Making sure our customers have enough water, whilst leaving more water in the environment</b> – including reducing the current levels of leakage and reducing the average amount of water that customers consume.</p>	<p><b>Providing a value for money service</b> – including carrying out a value for money survey to establish a baseline against which performance will be measured and improved by the end of AMP6.</p>
<p><b>Supplying high quality water you can trust</b> – including maintaining current level of compliance with water quality standards.</p>	
<p><b>Minimising disruption to you and your community</b> – including ensuring assets are kept in a stable condition to protect customers.</p>	

For household retail, all companies, including South West Water and Affinity Water, will be measured against the service incentive mechanism (SIM) retail outcomes.

### **Allowed costs and returns**

Table 4 below sets out the core components of our draft determinations in respect of allowed costs and returns – for each of the four separate price controls for South West Water, and the three separate price controls for Affinity Water (in the 2012-13 price base used in the business plans).

**Table 4 Summary costs and returns**

	Allowed costs/expenditure	South West Water	Affinity Water
Household retail	Cost allowance – 2015-20 total (£m)	143.06	123.86
	Margin (%)	1.00	1.00
	Average bill per household customer – retail component only (£)	45	20
Non-household retail	Cost allowance – 2015-20 total (£m)	10.659	15.540
	Margin (%)	2.50	2.50
Wholesale water	Totex – 2015-20 total (£m)	706.942	1,082.765
	Allowed cost recovery in 2015-20 <sup>1</sup> (£m)	662.308	1,039.622
	Allowed weighted average cost of capital (%)	3.70	3.70
	Allowed wholesale revenue in 2015-20 <sup>2</sup> (£m)	905.277	1,250.984
Wholesale wastewater	Totex – 2015-20 total (£m)	881.305	–
	Allowed cost recovery in 2015-20 <sup>1</sup> (£m)	894.213	–
	Allowed weighted average cost of capital (%)	3.70	–
	Allowed wholesale revenue in 2015-20 <sup>2</sup> (£m)	1,214.182	–

**Notes:**

1. Includes pay-as-you-go (PAYG) expenditure and depreciation – but does not include return on capital or tax, and is not adjusted for income from other sources or capital contributions or revenue from connection charges.
2. Includes a return on regulatory capital value (RCV), depreciation on RCV, PAYG expenditure, tax allowance, and adjustments based on 2010-15 performance. Also adjusted to deduct income from other sources, to add capital contributions from connection charges and revenue from infrastructure charges, to add ex ante additional menu income and to make other modelling adjustments.

Under the price limits within these draft determinations, investors will earn fair returns for the risks they are taking provided the companies deliver the plans and commitments. And if they are able to outperform on their plans, they will be able to share additional rewards with their customers. We consider that the potential for

companies to earn additional financial rewards provides a strong incentive for them to deliver additional value for their customers and to outperform their allowed costs.

A summary of the appendices which provide further detail is set out in table 5 below.

**Table 5 Summary of appendices**

	Summary	Appendix
<b>Draft determinations</b>		
Draft determination for South West Water	We explain the derivation of each price control, and set out key metrics for the wholesale water, wholesale wastewater, retail, and retail non-household price controls. We also explain our approach to whole company issues, including financeability.	Company-specific appendix – South West Water
Draft determination for Affinity Water	We explain the derivation of each price control and set out key metrics for the wholesale water, retail and retail non-household price controls. We also explain our approach to whole company issues, including financeability.	Company-specific appendix – Affinity Water
<b>Supporting information</b>		
Outcomes	We explain how we have reflected the companies' outcomes in the draft determinations. We also include details of how we set out our expectations around transparency for customers on how the companies will demonstrate that they are delivering against the outcomes and performance commitments.	Technical appendix, chapter A1
Wholesale costs	We set out important information to allow stakeholders to understand the approach we have taken to setting allowances for wholesale water and wastewater expenditures. We explain how we have moved from the cost thresholds in the risk-based review to the baselines used in the draft determinations.	Technical appendix, chapter A2

	Summary	Appendix
<b>Supporting information</b>		
Retail price controls	We provide an overview of how we calculate the allowed household retail costs and applied the associated net margins (at levels consistent with our risk and reward guidance), and set out the next steps, including our further work on non-household retail controls.	Technical appendix, chapter A3

## Final determinations for South West Water and Affinity Water

**We invite comments on these draft determinations by 4 June 2014.**

In setting our final determinations for South West Water and Affinity Water, we will take all relevant information into account. Therefore, we will be considering further information related to:

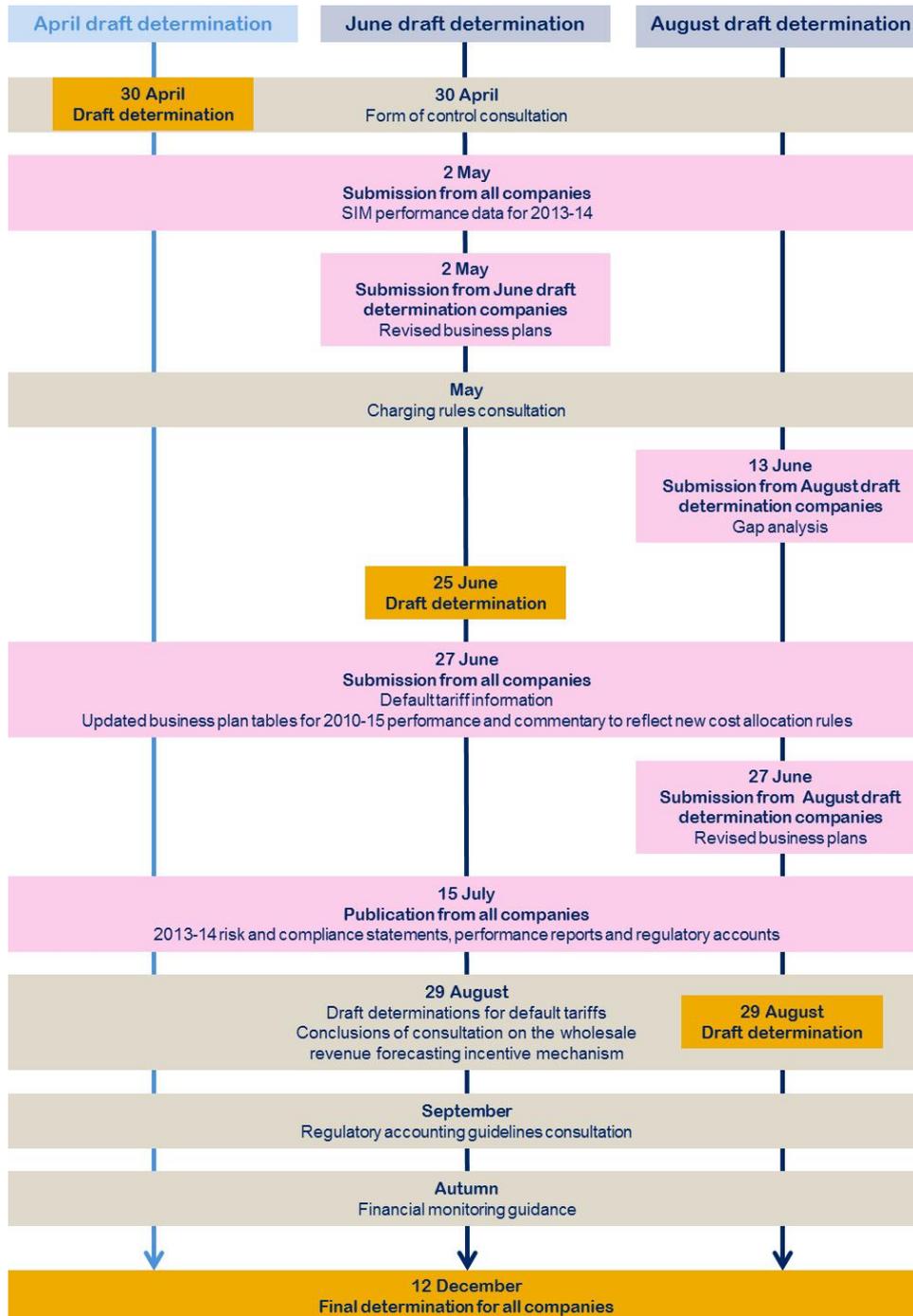
- representations from companies and other stakeholders on these draft determinations;
- updated information submitted by companies as requested by us – for example, updated reported actual performance in 2013-14 and projected performance in 2014-15 (set out in figure 1 below); and
- policy that forms part of the wider price control package, which we will publish later in the price control process (set out in figure 1 below).

Our process will allow South West Water and Affinity Water, and their stakeholders, to fully consider and respond to the various components of the price control framework in advance of us setting our final determinations. As we confirmed in [‘Setting price controls for 2015-20 – decisions on enhanced companies and next steps’](#), South West Water and Affinity Water will not be disadvantaged by receiving their draft determinations at an earlier stage.

## Next steps – relevant to all companies

The remaining steps in the price review for all companies are summarised in figure 1 below.

**Figure 1 Remaining steps of the price review process**



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