August 2014

Setting price controls for 2015-20

Draft price control determination notice: company-specific appendix – Sutton & East Surrey Water

OFWAT

Contents

Correction

The return on regulated equity range and figure A5.1 on pages 33 and 34 (and page 6) together with figure AA4.2 on page 59 setting out the financial outcome delivery incentives were updated on 29 September 2014.

Overview

This appendix sets out the details of the draft determination of price controls that are specific to Sutton & East Surrey Water. Our draft determination is based on Sutton & East Surrey Water's business plan as submitted by 27 June and its responses to our subsequent queries.

Sutton & East Surrey Water has not revised its plan substantially from what it submitted in December. It has now applied efficiencies across the plan, and has provided further evidence in support of the issues that were identified as part of the risk-based review. We have, however, needed to intervene in a number of targeted areas in the revised plan. These interventions include disallowing a number of claims for wholesale costs, rejecting the company's claim for a specific uplift to the cost of capital and rejecting the company's proposals for uncertainty mechanisms. There are further interventions in the plan designed to safeguard customers' interests, including around outcomes and the associated delivery incentives which are common to all companies.

It should be noted that in order for the price controls to protect the interests of consumers, we consider that – in accordance with their licence obligations – companies must act in an economic and efficient manner in all circumstances. For the avoidance of doubt, this obligation overrides any individual incentive element.

This draft determination sets out the draft allowed revenues and K factors for Sutton & East Surrey Water, along with what they mean for average customer bills. We have summarised this information in the 'draft determination at a glance section'. The draft determination also sets out:

- the outcomes we expect the company to deliver under each price control;
- the costs we are assuming the company will incur and, where appropriate, the assumptions we have made to arrive at the allowed revenue for each price control;
- the adjustments we are making to the wholesale water controls to reflect the company's performance in 2010-15; and
- our assumptions on risk and reward, including the uncertainty mechanisms that form part of each price control.

As part of this price review, we stated in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'final methodology statement') that we would be setting separate price controls for wholesale and retail elements of the appointee business. We explained that these separate controls would be binding, confirmed through the modifications made to the price setting elements of companies' licence conditions.

This means that the companies cannot recover more revenue than allowed under each specific price control. The revenue allowance for each price control is determined by the costs specific to that particular price control. This means that companies cannot cross-subsidise between controls in terms of costs or revenues, which gives important benefits for providing more effective incentives. It also supports the development of the relevant markets and in particular those provided for by the Water Act 2014.

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

This draft determination is structured on an element-by-element basis and is separated into:

- wholesale water;
- household retail; and
- non-household retail.

In each area, we have set out the relevant information after our interventions – that is, our draft determination. In those areas in which we have intervened, we discuss the difference between our view and the company view further in the specific annexes where appropriate.

At the appointee level, this draft determination sets out our view of the company's financeability over the period 2015-20.

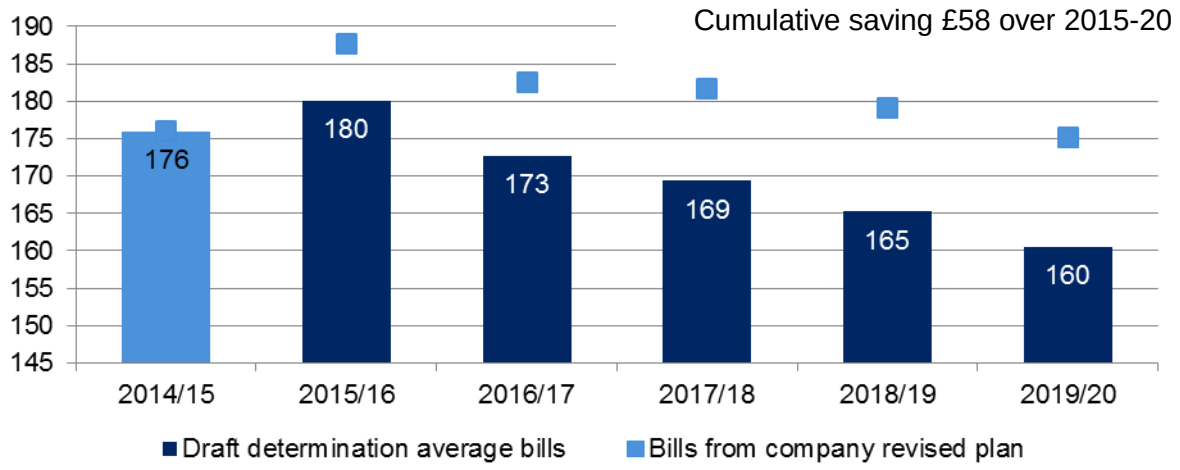
Annexes 1 to 4 form part of the draft price control determination.

A1 Draft determination – at a glance

In this section, we set out what the draft determination means:

- for customers, with respect to the average bills they will pay and the outcomes that the company will deliver in return; and
- for the company, with respect to the allowed costs/expenditure, return on regulatory equity (RoRE) WACC range; financial ratios (under the notional structure) and the interventions we made to the company's revised plan.

Average household bill (£)



Note:

The 'bills from company revised plan' is based on the data submitted by the company in its business plan but projected using our financial model, thereby ensuring consistency with the draft determination projection. As a consequence the company's proposed bills illustrated above may not necessarily be the same as those described in the revised business plan.

Outcomes

Wholesale water
Provide a reliable and sufficient supply of safe high quality drinking water
Increasing the resilience of our network to drought, flooding and equipment failure
Reducing our impact on the environment while seeking to make a positive contribution to its quality
Retail
Offering good value for money and keeping bills at a fair and reasonable level
Delivering consistently high levels of service

Allowed costs/expenditure[1]

Wholesale	Water	
Totex – 2015-20 total (£m)	228.8	
Allowed weighted average cost of capital (%)	3.70%	
Allowed wholesale revenue in 2015-20 (£m)	252.8	
Retail	**Household**	**Non-household**
Cost allowance – 2015-20 total (£m)	23.2	
Margin (%)	1.00%	2.50%
Retail allowed revenue (£m)	25.8	3.8
Average bill per household customer – retail component only (£)	19	

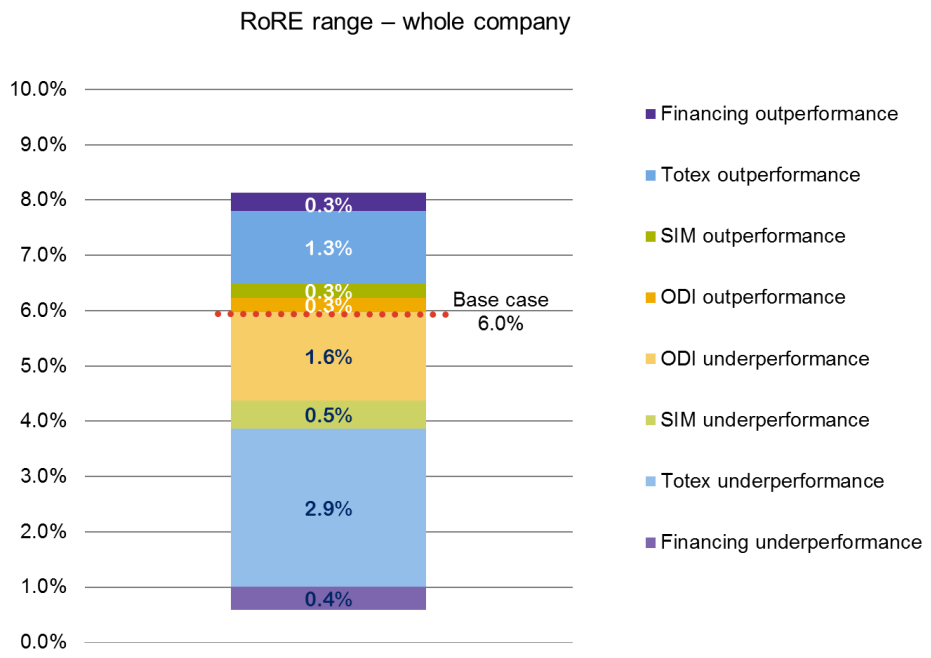
Notes:

[1]Wholesale figures in 2012-13 prices and retail figures in nominal prices – this is consistent throughout this draft determination unless otherwise stated.

Summary of interventions

Outcomes • **Cap:** We have imposed an overall cap and collar on outcome delivery incentives of +/- 2% of RoRE. • **Horizontal check:** We have made one performance commitment more stretching and tightened a penalty deadband for a further performance measure. • **Bottom-up analysis:** We removed the reward for one performance measure, reduced the reward rate for another, added a penalty for a further performance measure and adjusted a number of incentives to increase the range of performance over which a penalty applies.	**Wholesale costs** • The company proposed wholesale water totex of £234 million in its plan which is £7 million above our draft determination threshold of £227 million. • We have rejected some of the company's wholesale cost adjustments and partially allowed others.
Retail • We have rejected the company's proposed adjustment for input price pressure (household).	**Reconciling 2010-15 performance** • We have made minor interventions in this area.
Risk and reward • We have rejected Sutton & East Surrey Water's proposed company specific uplift to the WACC of 50bps. • We have removed the uncertainty mechanisms for water framework directive and open water costs.	**Financeability and affordability** • We expect further Board and third party assurance that it is financeable on a notional basis.

RoRE ranges – wholesale water



Ofwat's calculations of notional financeability ratios

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Cash interest cover	3.47
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.22
Funds from operations/debt	11.62%
Retained cash flow/debt	8.95%
Gearing	64.52%
Dividend cover (profit after tax/dividends paid)	2.11
Regulatory equity/regulated earnings for the regulated company	16.84
RCV/EBITDA	9.36

A2. Wholesale water

A2.1 Company outcomes, performance commitments and delivery incentives

A2.1.1 Outcomes, performance commitments and incentives

In the outcomes technical appendix, we discuss our approach to outcomes for the wholesale and retail controls.

We summarise the outcomes, performance commitments (PC) and outcome delivery incentives for the wholesale water control for Sutton & East Surrey Water in table A2.1 below.

We are intervening to impose an overall cap and collar on outcome delivery incentives for the 2015-20 period, thereby limiting total rewards and penalties. The maximum rewards for outperformance will be limited to +2% of RoRE and maximum penalties for underperformance are limited to -2% of RoRE. This will help ensure that the overall package of delivery incentives is calibrated to provide meaningful financial incentives and protect customers.

For some performance commitments and incentives types, we have intervened to change the underlying performance level or incentives. These interventions are listed in table A2.1. Full detail of the wholesale water outcomes, performance commitments and incentives is provided in annex 4.

Table A2.1 Wholesale water outcomes, performance commitments and incentives

Company proposal			Intervention
Outcome	**Performance commitment**	**Incentive type**	
Provide a reliable and sufficient supply of safe high quality drinking water	Security of Supply Index (SOSI) dry year average	Non-financial	**Bottom-up analysis:** We have added a financial penalty to protect customers
	SOSI Critical period	Non-financial	No Intervention
	Supply interruptions	Financial – reward and penalty	**Horizontal check:** We have adjusted the performance commitment so that by 2017-18 it reflects current upper quartile performance
	Condition of mains network	Financial – penalty only	**Bottom-up analysis:** We have tightened the penalty deadband
	Drinking water inspectorates Index of Water Quality	Financial – penalty only	**Horizontal check:** We have tightened the penalty deadband
	Number of contacts about taste, odour and discolouration	Financial – reward and penalty	No intervention
Increasing the resilience of our network to drought, flooding and equipment failure	The number of times on average we have to impose restrictions on water use	Non-financial	No intervention
	Percentage of properties that are connected to more than one treatment works	Financial – reward and penalty	**Bottom-up analysis:** We have reduced the reward rate
Reducing our impact on the environment while seeking to	Levels of leakage measured in litres per day	Financial – reward and penalty	**Bottom-up analysis:** We have tightened the penalty deadband

Company proposal			Intervention
Outcome	**Performance commitment**	**Incentive type**	
make a positive contribution to its quality	Per capita consumption in litres per day	Financial – reward and penalty	**Bottom-up analysis:** We have removed the reward as it was not sufficiently justified
	Children and adults engaged in environmental education	Non-financial	No intervention
	Greenhouse gas emissions per million litres of water supplied	Non-financial	No intervention
	Number of severe pollution incidents	Non-financial	No intervention
	Environmental Directives	Non-financial	No intervention

A2.1.2 Outcome delivery and reporting

In the assurance technical appendix, we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015-20 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price limits and during the regulatory period itself.

We are satisfied with the company's proposals for self reporting. But consistent with the commentary in our assurance technical annex, we will need to consider the categorisation of the company for assurance purposes at the final determination.

Sutton & East Surrey Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach is summarised in annex 4.

A2.2 Calculating the wholesale water price control

A2.2.1 Calculating allowed wholesale water expenditure

Our approach to calculating allowed wholesale expenditure is set out in the wholesale water and wastewater technical appendix.

In Sutton and East Surrey's revised plan the company proposed wholesale water totex of £234 million over 2015-20. We calculated the draft determination menu cost threshold at £227 million, giving rise to a difference of £7 million or 3.1%. There are no further adjustments that we consider we could have made as all other claims are fully covered by implicit allowances. We also note that the company made representations to our cost models following the publication of these in April. The representations made and our response is summarised in wholesale water and wastewater technical appendix.

The actual gap faced by the company against our totex threshold is smaller than that implied by the gap. This is because the use of menus and our approach to setting baselines reduces the difference faced by the company. The difference between the company's plan and the amount it would ultimately recover from customers is only 1.7%.

The proposed wholesale water allowed expenditure for Sutton & East Surrey Water is detailed in table A2.2 below. We provide a further breakdown of some of the calculations in annex 1. Further information about our assessment of each claim is set out in the populated version of the draft determination initial cost threshold models.

Table A2.2 Wholesale water allowed expenditure (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Draft determination cost threshold						227.4
Costs excluded from menu						6.9
Menu cost baseline[1]	40.9	45.1	47.4	43.8	43.5	220.5
Company's view of menu costs[2]						226.8
Implied menu choice						102.8
Allowed expenditure from menu	41.1	45.4	47.7	44.1	43.8	222.1
Costs excluded from menu	1.4	1.4	1.4	1.4	1.4	6.9
Total allowed expenditure[3]	42.6	46.8	49.1	45.4	45.1	229.0
Less pension deficit repair allowance	0.0	0.0	0.0	0.0	0.0	0.2
Totex for input to PAYG	42.5	46.7	49.1	45.4	45.1	228.8

Notes:

1. Menu baseline is equal to the draft determination threshold less pension deficit recovery costs, third party costs and market opening costs related to 2014-15 (see annex 1).
2. Based on company plan totex minus costs for items excluded from the menu.
3. Includes pension deficit repair allowance.

A2.2.2 Calculation of rRevenues: 'pay-as-you-go' PAYG and RCV-run off

Table A2.3 shows the company's proposed PAYG ratios and associated totex recovery for wholesale water, which we have used as the basis for this draft determination.

Table A2.3 Sutton & East Surrey Water wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£m)	42.5	46.7	49.1	45.4	45.1	228.8
PAYG %	64.7%	59.8%	57.2%	60.8%	60.2%	60.5%
Resulting PAYG (£m)	27.5	27.9	28.1	27.6	27.2	138.3

Table A2.4 shows the company's proposed RCV run-off amounts included within the wholesale water charge. This reflects a run-off rate of 7.56% for the RCV as at 31 March 2015 and 53 years for the totex additions to the RCV over 2015-20.

Table A2.4 Sutton & East Surrey Water wholesale water RCV run-off (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Run-off of 2015 RCV	15.6	13.9	13.1	12.6	11.7	67.0
RCV run-off of totex additions	0.1	0.5	0.8	1.2	1.5	4.2
Total RCV run-off	15.8	14.4	13.9	13.8	13.3	71.1

A2.2.3 Return on the RCV

Sutton & East Surrey Water has asked for a company specific uplift of 0.50% of the wholesale WACC of 3.70% set out in the risk and reward guidance. We have considered whether this it would be appropriate to allow for this uplift based on the approach we set out in our risk and reward guidance.

> **"To justify a company specific uplift in the WACC, companies will need to demonstrate both that they face a higher cost to raising finance and that there is an offsetting benefit to customers."[1]**

[1] Ofwat (January 2014), 'Setting price controls for 2015-20 – risk and reward guidance',p23, (http://www.ofwat.gov.uk/pricereview/pr14/gud_tec20140127riskreward.pdf).

As set out in the risk and reward technical appendix, we consider that Sutton & East Surrey Water, in common with five other small water only companies, faces higher cost of raising debt, which would be 25 basis points above the cost of debt of 2.75% set out in the risk and reward guidance. This means that the company passed test 1: higher finance costs.

Consistent with our guidance, we have then considered whether there would be offsetting benefits to customers from providing this company specific uplift to Sutton & East Surrey Water. For the reasons set out in the risk and reward technical appendix, the company did not pass test 2.

While direct evidence from customers is valuable, it is not a substitute for demonstrating benefits to customers. We are also concerned that the customer research conducted by the company to demonstrate support for the Small Company Premium only provided respondents with limited information which may not have been understood by customers.

We have therefore concluded that it would not be efficient for customers to face the incremental costs of finance and therefore have concluded that there should not be an adjustment to the wholesale cost of capital.

We have therefore intervened and used a wholesale water cost of capital of 3.70% in this draft determination. This results in a return on capital of £39.6 million over 2015-20.

Table A2.5 shows our calculation of the opening RCV at 1 April 2015 taking account of the adjustments for 2010-15 performance discussed in section A2.2.4 below. The average RCV, set out in Table A2.6 for each year, takes into account the proportion of totex additions to the RCV determined by the PAYG ratio and RCV run-off.

Table A2.5 Sutton & East Surrey Water wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	209.1
Land sales	0.0
Adjustment for actual expenditure 2009-10	3.8
Adjustment for actual expenditure 2010-15[1]	-6.5
Net adjustment from logging up, logging down and shortfalls	0.0
Other adjustments	0.0
Opening RCV 1 April 2015	206.4

Note:

1. The adjustment for actual expenditure 2010-15 is explained further in annex 3 as part of the CIS adjustment

Table A2.6 Sutton & East Surrey Water wholesale water return on RCV (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	206.4	205.7	210.1	217.2	221.2
RCV additions (from totex)	15.0	18.8	21.0	17.8	17.9
Less RCV run-off	15.8	14.4	13.9	13.8	13.3
Closing RCV	205.7	210.1	217.2	221.2	225.8
Average RCV (year average)	206.0	207.9	213.6	219.2	223.5
Return on capital	7.6	7.7	7.9	8.1	8.3

A2.2.4 Reconciling 2010-15 performance

The company proposed adjustments to the opening RCV and allowed revenue for the wholesale water services to reconcile performance in 2010-15. We have intervened and as a result the revenue adjustments for wholesale water have reduced 2010-15 revenue adjustments for wholesale water from £7.6 million to £7.4 million. We summarise these interventions in table A2.7 below, and quantify the resulting adjustments within this draft determination in table A2.8. The impact on the opening RCV of 2010-15 adjustments is shown in table A2.5 and we discuss our interventions in this area further in annex 3.

Table A2.7 Sutton & East Surrey Water wholesale water revenue adjustments to reflect 2010-15 performance (£ million)

Area	Intervention	Why we did it	Total 2010-15
Service incentive mechanism (SIM)	SIM performance reward has increased.	To reflect updated industry performance in line with the methodology.	0.3
Revenue correction mechanism (RCM)	We have intervened in the following areas. • Forecast 2014-15 tariff basket revenue. • Number of households billed. • FD09 assumptions. • Outturn financial year average RPI. • PR14 discount rate.	We have concerns on the company's forecast 2014-15 tariff basket revenues, FD09 assumptions, data inconsistencies, and application of discount rate.	9.3
Opex incentive allowance (OIA)	There are no interventions in this area.	n/a	1.5

Area	Intervention	Why we did it	Total 2010-15
Capital expenditure incentive scheme (CIS)	We have used the values submitted in table A9 in the CIS model. We have profiled the revenue adjustment as a constant annuity. We have used our assumption of the cost of capital (3.70%) as the discount rate when profiling the revenue adjustment.	The company has broadly applied the published Ofwat methodology. However: • the company has submitted an early version of the CIS model (v2) that does not contain the profiling functionality. The company states it has profiled the revenue adjustment using option 1 (constant annuity option) however the sum of the annual values entered in table W20 equal the single year adjustment; and • RPI details in the company's CIS model are inconsistent with submitted table A9.	-3.6
Other adjustments	There are no interventions in this area.	n/a	0.0
Total	n/a	n/a	7.4

A2.2.5 Calculation of allowed revenue

We set out the calculation of the allowed revenue for Sutton & East Surrey Water's wholesale water control in table A2.8.

Overall, after taking into account our interventions and using the companies' proposed PAYG ratio and run off rate set out in section A2.2.2, the company's wholesale water revenue allowance is £52.3million in 2015-16, decreasing by 6.2% to £49.1million in 2019-20. We set out in section A5.3 below that Sutton and East Surrey should engage with customers and consider proposing changes to the PAYG ratio or RCV run off rate in its representations.

Table A2.8 Sutton & East Surrey Water wholesale water allowed revenue (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex	42.5	46.7	49.1	45.4	45.1	228.8
PAYG ratio	64.73%	59.80%	57.19%	60.80%	60.22%	-
Totex additions to the RCV	15.0	18.8	21.0	17.8	17.9	90.5
RCV (year average)	206.0	207.9	213.6	219.2	223.5	-
Wholesale allowed revenue build up:						
PAYG[1]	27.6	28.0	28.1	27.6	27.2	138.5
Return on capital	7.6	7.7	7.9	8.1	8.3	39.6
RCV run-off	15.8	14.4	13.9	13.8	13.3	71.1
Tax[2]	1.2	0.7	0.3	0.3	0.1	2.7
Income from other sources[3]	-1.8	-1.8	-1.8	-1.8	-1.8	-9.2
Reconciling 2010-15 performance	1.5	1.5	1.5	1.5	1.5	7.4
Ex-ante additional menu income	-0.1	-0.2	-0.2	-0.2	-0.2	-0.8
Capital contributions from connection charges and revenue from infrastructure charges	0.7	0.7	0.7	0.7	0.7	3.5
Final allowed revenues	**52.3**	**50.9**	**50.4**	**50.0**	**49.1**	**252.8**

Notes:

1. PAYG includes the PAYG calculated from totex and the pension deficit repair allowance.
2. Including tax on adjustments for reconciling 2010-15 performance and ex-ante additional menu income.

3. We have adjusted Sutton & East Surrey Water's proposed other income to remove the connection and infrastructure charges that it included. We have reflected this revenue under 'Capital contributions from connection charges and revenue from infrastructure charges' in line with the business plan guidance. This will ensure that the revenue is treated correctly in our calculation of allowed revenues.

A2.3 Uncertainty mechanisms

We outline our approach to uncertainty mechanisms in the risk and reward technical appendix. In table A2.9 below, we set out Sutton & East Surrey Water's proposed wholesale water uncertainty mechanisms and our assessment of these proposals.

Table A2.9 Sutton & East Surrey Water proposals for wholesale water uncertainty mechanisms

Sutton & East Surrey Water proposals	Our assessment
Sutton & East Surrey Water proposed a true-up mechanism for water business rates.	We consider that the materiality, comparability and control over risk criteria for water business rates are met. We have included a 75%:25% uncertainty mechanism for all companies consistent with our prior guidance and earlier draft determinations. The specific text of this Notified Item and the rationale for its inclusion in the draft determination is set out in the risk and reward technical appendix.
Sutton & East Surrey Water proposed a true-up mechanism for costs arising due to the Water Framework Directive, with a sharing rate of 100:0.	We do not accept the need for an uncertainty mechanism in this area, as the potential spending involved is too small for this risk to be material, as Sutton & East Surrey Water has substantial opportunities to mitigate the impact of this risk should it arise and Sutton & East Surrey Water has not provided adequate justification why it is in a different position to all other companies which would face substantially similar risks with regard to the Water Framework Directive. **Materiality: Fail** The downside scenario presented by Sutton & East Surrey Water for costs arising from the Water Framework Directive represent a combined variance of about 0.3% of wholesale totex over the whole of 2015-20, which is too small to be material. **Controllability: Fail** Sutton & East Surrey Water has some control over the amount it spends on any given project mandated under the Water Framework Directive. **Comparability with other companies: Fail** This risk is well understood and common to all companies. Sutton & East

Sutton & East Surrey Water proposals	Our assessment
	Surrey Water has not provided adequate justification to demonstrate why it requires specific protection from these risks when other companies have not. **Customer protection: Fail** We consider that it would be inappropriate for Sutton & East Surrey Water customers to bear 100% of this risk when customers of all other companies bear only a portion of the risk with their respective companies through the totex menu.
Sutton & East Surrey Water proposed a true-up mechanism for costs arising due to the Open Water programme, with a sharing rate of 100:0.	We do not accept the need for an uncertainty mechanism in this area, as the potential spending involved is too small for this risk to be material and Sutton & East Surrey Water has not provided adequate justification why it is in a different position to all other companies which would face substantially similar risks with regard to Open Water. **Materiality: Fail** The downside scenario presented by Sutton & East Surrey Water for Open Water spending represents a combined variance of about 0.1% of wholesale totex over the whole of 2015-20, which is too small to be material. **Controllability: Pass** We accept that the budget for Open Water is substantially outside Sutton & East Surrey Water's control. **Comparability with other companies: Fail** This risk is well understood and common to all companies. Sutton & East Surrey Water has not provided adequate justification to demonstrate why it requires specific protection from these risks when other companies have not. **Customer protection: Fail** We consider that it would be inappropriate for Sutton & East Surrey Water customers to bear 100% of this risk when customers of all other companies bear only a portion of the risk with their respective companies through the totex menu.

A3. Household retail

A3.1 Company outcomes, performance commitments and delivery incentives

In the outcomes technical appendix, we discuss our approach to outcomes for the wholesale and retail controls.

We summarise the outcomes, performance commitments and outcome delivery incentives for the household retail control for Sutton & East Surrey Water in table A3.1 below.

For some performance commitments and incentives types, we have intervened to change the underlying performance level or incentives. These interventions are listed in **Error! Not a valid bookmark self-reference.** below. Full detail of the wholesale water outcomes, performance commitments and incentives is provided in annex 4.

Table A3.1 Household retail outcomes, performance commitments and incentives

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Offering good value for money and keeping bills at a fair and reasonable level	Number of customers in water poverty	Non-financial	No Intervention
	Effectiveness of bad debt recovery	Non-financial	No Intervention
	Customer perception of value for money	Non-financial	No Intervention
Delivering consistently high levels of service	Customer satisfaction	Non-financial	No Intervention
	Service incentive mechanism	Non-financial	No Intervention
	Total number of complaints	Non-financial	No Intervention

A3.1.1 Outcome delivery and reporting

We are satisfied with the company's proposals for self-reporting. But consistent with the commentary in our assurance technical annex, we will need to consider the categorisation of the company for assurance purposes at the final determination.

Sutton & East Surrey Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach is summarised in annex 4.

A3.2 Costs

Our approach to the household retail control is set out in the household retail technical appendix.

A3.2.1 Allocation of costs

In table A3.2 below, we summarise our assessment of Sutton & East Surrey Water's cost allocation methodology.

Table A3.3 Our assessment of Sutton & East Surrey Water's cost allocation methodology

Area assessed	Assessment
No potential material misallocations	Fail
Adequate assurance provided	Pass
Reconciliation to regulatory accounts and December business plan provided	Pass
Correct price base used	Pass

We have used the company's costs to set our draft determination. However, we noted the following issues with respect to the company's cost allocation.

- The company has not allocated local authority rates, IT costs and facilities and grounds maintenance between retail and wholesale in accordance with our guidance.

- The company has not complied with the principal use guidance with respect to the allocation of capital costs and depreciation.

- The company has not allocated doubtful debts and facilities and grounds maintenance between household and non-household in accordance with our guidance.

In order to address the issues that we have identified, we expect the company to submit the following information to us with its draft determination representations, by 3 October at the latest.

- Cross-check of its allocation of doubtful debts based on write offs against an allocation based on the movement in outstanding debt and present us with the results of this cross check (that is, how different would the allocation between household and non-household be based on the movement in outstanding debt from 31 March 2013 to 31 March 2014).

- Revised table R3 and R4 with capital costs and depreciation allocated in accordance with our principal use guidance, including the allocation of general and support asset depreciation between retail and wholesale in accordance with our guidance.

- Calculation demonstrating what the allocation of local authority rates, IT costs and facilities and grounds maintenance between retail and wholesale would be in line with our guidance, and in the event that the difference to the current business plan allocation is in excess of our materiality for allocations between retail and wholesale (greater than 2% of R3 line 1 plus R4 line 1) update these allocations in the revised R3 and R4 tables.

- Calculation demonstrating what the allocation of facilities and grounds maintenance between household and non-household would be in line with our guidance, and in the event that the difference to the current business plan allocation is in excess of our materiality for allocations between household and non-household (greater than 2% of R4 line 1) update these allocations in the revised R3 and R4 tables.

While reviewing the company's cost allocations, we also noted that the company had included a one-off pension curtailment gain in Tables R3 and R4. This is not in line with our guidance which requires that exceptional/one-off items are excluded from business plan submissions. We have amended our models to remove the household element of the one-off gain (£247k) from R3 but we have made no adjustment to R4 as the non-household element of the gain (£15k) is not considered to material to R4.

A3.2.2 Adjustments

Below, we outline Sutton & East Surrey Water's proposed average cost to serve (ACTS) adjustments and our assessment of these proposals. The adjustments proposed by Sutton & East Surrey Water and Ofwat are quantified in table A3.3.

Table A3.4 Sutton & East Surrey Water proposals for ACTS adjustments

		Adjustment assessment criteria			
Adjustment	Value (£m over 2015-20)	Materiality	Beyond efficient management control	Impact company in materially different way	Value of adjustment appropriate
Input price pressure	4.0	Pass	Fail	Efficiency benchmarking evidence: Fail Upper quartile: Pass	Pass

Sutton & East Surrey Water proposed an adjustment for Input Price Pressure (IPP) for £4.0 million over 2015-20.

Ofwat rejects Sutton & East Surrey Water's proposal for an ACTS adjustment for input price pressure. Sutton & East Surrey Water does not show that these costs are outside of efficient management control or demonstrate that they are affected in a materially different way to other companies.

The value of the adjustment is material, at 12.7% of household retail operating expenditure plus depreciation over 2015-20.

We do not consider that the evidence provided on management practices is sufficient and convincing that the company manages its costs to the extent that future cost increases are outside of efficient management control.

The evidence provided on relative efficiency benchmarking is limited. Qualitative evidence on input price pressure in the energy retail sector is discussed. We do not consider that sufficient evidence has been provided to demonstrate that Sutton & East Surrey Water is an efficient retailer compared to companies outside of the water industry.

Our assessment for ACTS suggests that the company is upper quartile efficient for unmetered household retail costs, but not for the additional costs of metering. This assessment is subject to change up to final determination for example, subject to cost allocation changes being made by companies that could affect the ACTS. Because of the limited evidence provided on relative efficiency benchmarking, we do not consider that the company has not demonstrated that they are affected in a materially different way to the average company.

Although we do not consider that an adjustment for input price pressure is appropriate for Sutton & East Surrey Water, for completeness we have assessed the evidence provided on the size of an adjustment. The size of the adjustment is calculated bottom up from relevant inflation rates for appropriate cost areas. This appears to be a reasonable approach.

Table A3.5 Household retail adjustments (£ million, nominal prices)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Adjustments proposed in Sutton & East Surrey Water's business plan						
Input price pressure	0.460	0.639	0.856	1.054	1.251	4.260
Pension deficit repair costs	0.022	0.022	0.023	0.024	0.025	0.115
Outcome 2: Debt management	0.036	0.036	0.036	0.036	0.036	0.180
Adjustments included in business plan	**0.518**	**0.697**	**0.915**	**1.114**	**1.312**	**4.555**
Adjustments included in draft determination						
Input price pressure	0.000	0.000	0.000	0.000	0.000	0.000
Pension deficit repair costs	0.008	0.008	0.008	0.008	0.008	0.040
Outcome 2: Debt management	Not included as adjustment – forms part of new cost					
Adjustments included in draft determination	**0.008**	**0.008**	**0.008**	**0.008**	**0.008**	**0.040**

Note:

There will be no indexation for retail price controls.

A3.2.3 New costs

Sutton & East Surrey Water did not propose plans that incurred material incremental household retail costs.

Table A3.6 New household retail costs (£/customer)

	Value
Modification made to 2013-14 CTS for ACTS calculation	0.00

Note:

There will be no indexation for retail price controls from this 2012-13 price base.

A3.3 Calculating the allowed revenues

Using the average industry allowances per customer, and the projected customer numbers in the company's revised business plan, we have calculated the total allowed household retail revenues, including the efficiency challenge and the household retail net margin.

A3.3.1 Net margins

The table below shows the household retail net margin over 2015-20.

Table A3.7 Household retail net margins (%)

	2015-16	2016-17	2017-18	2018-19	2019-20
Household retail net margin	1.0%	1.0%	1.0%	1.0%	1.0%

Table A3.7 below sets out the components of the allowed household retail revenue.

Table A3.8 Components of the allowed household retail revenue (nominal prices)

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Company cost to serve (£/customer)						
Unmetered single service customers	15.68					
Metered water only customers	30.08					
Industry average cost to serve (£/customer)						
Unmetered single service customers						20.73
Metered water only customers						26.78
Allowed cost to serve[1] (£/customer)						
Unmetered single service customers		12.94	12.51	12.93	12.49	11.93
Metered water only customers		25.25	22.73	21.07	18.54	17.98
Total allowed (£ million)						
Cost to serve (excluding net margin)		5.0	4.8	4.7	4.4	4.3
Forecast household wholesale charge (including forecast RPI[2])[3]		56.6	56.9	58.3	59.8	60.4
Household retail revenue (including an allowance for the net margin)[4]		5.6	5.3	5.2	4.9	4.8

Notes:

There will be no indexation for retail price controls.

1. Allowed cost to serve includes pension deficit repair costs.
2. The household wholesale charge includes forecast RPI so that the total household retail revenue can be displayed on the same price base as other retail costs.
3. The allocation of allowed wholesale revenue to different wholesale charges will be at the company's discretion, subject to charging rules and licence conditions.
4. This number is indicative as allowed revenue will depend upon actual customer numbers.

A3.4 Uncertainty mechanisms

We outline our approach to uncertainty mechanisms in the risk and reward technical appendix. In table A3.8 below, we set out Sutton & East Surrey Water's proposed household retail uncertainty mechanisms and our assessment of these proposals.

Table A3.9 Sutton & East Surrey Water proposals for household retail uncertainty mechanisms

Sutton & East Surrey Water proposals	Our assessment
Sutton & East Surrey Water did not propose any uncertainty mechanisms beyond those that will already form part of the regulatory framework for 2015-20.	

A4. Non-household retail

In the non-household retail technical appendix, we outline our overall approach to the non-household retail price control. Further information regarding our observations on companies' proposals for their non-household retail price controls is set out in 'IN 14/14: 2014 price review – non-household customer engagement ahead of draft determination representations'. In this chapter, we provide details of Sutton & East Surrey Water's non-household retail draft determination.

A4.1 Indicative non-household retail total revenue

Table A4.1 below shows the indicative total of non-household allowed revenue. The table is indicative, as it does not assume any gains or losses from competition or impacts from the company charging customers at levels different to the relevant default tariffs for the projected customers in each customer type.

Table A4.1 Indicative non-household retail total revenue price control including net margins (£ million, nominal prices)

	2015-16	2016-17	2017-18	2018-19	2019-20
Indicative non-household retail total revenue price control including net margins	0.7	0.7	0.8	0.8	0.8

Note:

There will be no indexation for retail price controls from this price base. The non-household wholesale charge includes forecast RPI so that the total non-household retail revenue can be displayed on the same price base as other retail costs. Figures exclude retail services to developers and revenues associated with miscellaneous charges.

A4.2 Net margins

The company proposed net margins that summated in aggregate to 2.5%. This is in line with our risk and reward guidance. We have therefore accepted the company's proposals.

A4.3 Cost proposals

Below we set out our interventions on the company's costs, including for:

- consistency with existing policy, including for example ensuring that companies cost information is presented in a consistent price base and pension deficit costs are presented as per our stated policy; and
- cost escalation, including for example material new investments or increases in costs or requests for input cost allowances.

In 'IN 13/17: Treatment of companies' pension deficit repair costs at the 2014 price review' we explained how we would treat the costs associated with water companies reducing the deficits in their defined benefit pension schemes at the 2014 price review. Where companies' proposals have differed from our calculations we have over-written their proposals in line with our overall approach.

This resulted in the company's proposals being adjusted from £0.010 million over the control period, to £0.006 million.

In total, this resulted in the company's proposed costs being adjusted from £2.360 million over the control period to £2.357 million.

The company's proposals are for overall cost decreases over the period – 29% from 2013-14 through to 2019-20. We crosschecked the magnitude of the decreases against the household control.

We also note that the company's opex in 2013-14 is significantly higher than the preceding two years. As part of its representations we require the company to provide us with a clear explanation as to the cost increase, and to explain why the increase should not be treated as an exceptional one-off event.

A5. Appointee

In this section, we discuss at an appointee level:

- bills and K factors;
- uncertainty mechanisms;
- return on regulated equity;
- financeability; and
- affordability.

A5.1 Bills and K factors

Table A5.1 below sets out the allowed revenues we have assumed in our draft determination for Sutton & East Surrey Water to deliver its:

- statutory duties;
- outcomes; and
- associated performance commitments.

It also sets out the average customer bills on the basis of the draft determination.

Table A5.1 Sutton & East Surrey Water's draft determination – K factors, allowed revenues and customer bills (in 2012-13 average prices)[1]

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water – allowed revenues (£m)[2]	52.3	50.9	50.4	50.0	49.1	252.8
Wholesale water – K (%)[3]	0.00%	-2.77%	-0.79%	-0.92%	-2.09%	–
Retail household allowed revenue (£m)	5.6	5.3	5.2	4.9	4.8	25.8
Retail non-household expected revenue (£m)	0.7	0.7	0.8	0.8	0.8	3.8
Average household bill – water (£)[4]	180	173	169	165	160	–

Notes:

1. Wholesale figures in 2012-13 prices & retail figures in nominal prices.
2. The allowed revenue for our draft determination is based on an implied menu choice. The company will have the opportunity to make its own menu choice, which will impact on its allowed revenues and customers' bills.
3. As discussed in the wholesale water and wastewater technical appendix, K is set to zero for 2015-16 for wholesale water because there are no directly equivalent wholesale revenues for 2014-15 (on account of the new price review structure). As such, there is no reference point against which to express a change in K.
4. It should be noted the average household bill illustrated above reflects a notional allocation (by Ofwat but based on the company's split of household and non-household customers) of the overall wholesale revenue requirement across Sutton & East Surrey Water's household and non-household customer base. In practice, this will depend upon the structure of wholesale charges implemented by Sutton & East Surrey Water.

We note that customer bills in the regulatory period from 2020 will be affected by Sutton & East Surrey Water's performance in the forthcoming regulatory period in relation to costs and the regulatory incentives in place for performance delivery and revenue projection performance.

A5.2 Uncertainty and gain share mechanisms

We outline our approach to uncertainty and gain share mechanisms in the risk and reward technical appendix. In Table A2.9A5.2 below, we set out Sutton & East Surrey Water's proposed appointee level uncertainty mechanisms and our assessment of these proposals.

Table A5.2 Sutton & East Surrey Water proposals for appointee level uncertainty and gain share mechanisms

Sutton & East Surrey Water proposals	Our assessment
Sutton & East Surrey Water has proposed a gain sharing mechanism for sharing dividends in excess of 10% with a sharing rate of 50% customer and 50% company.	Sutton & East Surrey Water can elect to pass on a reduction in bills in future periods due to higher returns in PR14 period without Ofwat's agreement and therefore we do not propose any intervention. However, we note that such a mechanism may not be consistent with incentive based regulation in that it might reduce the incentive for Sutton & East Surrey Water to seek cost efficiencies and outperform cost assumptions. The mechanism could also duplicate outperformance shared through the totex menus and it is unclear how the mechanism would take this into account. We do not propose PR19 totex reconciliation should take account of gain sharing undertaken by the company. The company should also consider how the arrangement would work alongside the proposed WFRIM mechanism, which may results in penalties for under or over recovery of revenue.

A5.3 Return on regulated equity range

We set out our approach to calculating the expected range in RoRE in the risk and reward technical appendix. The composition of the RoRE range for Sutton & East Surrey Water at an appointee level is shown in table A5.3 below.

Table A5.3 Whole Company RoRE range

	Lower bound (%) (appointee)	Upper bound (%) (appointee)
Overall	-5.4%	+2.1%
ODIs	-1.6%	+0.3%
Totex	-2.9%	+1.3%
Financing	-0.4%	+0.3%
SIM	-0.5%	+0.3%

Commentary:

The whole company RoRE range is from 0.6% to 8.1%, with a base case of 6.0%, not including the company-specific adjustment to the WACC, with overall impacts from -5.4% to +2.1%.

The totex range is -2.9% to +1.3% of notional equity. While this range is asymmetric, with Sutton & East Surrey Water forecasting a greater potential risk cost overrun than saving, we are satisfied that Sutton & East Surrey Water has appropriately taken into account historic cost variability to arrive at this estimate, and therefore this represents a sufficiently considered company view of its potential totex risk.

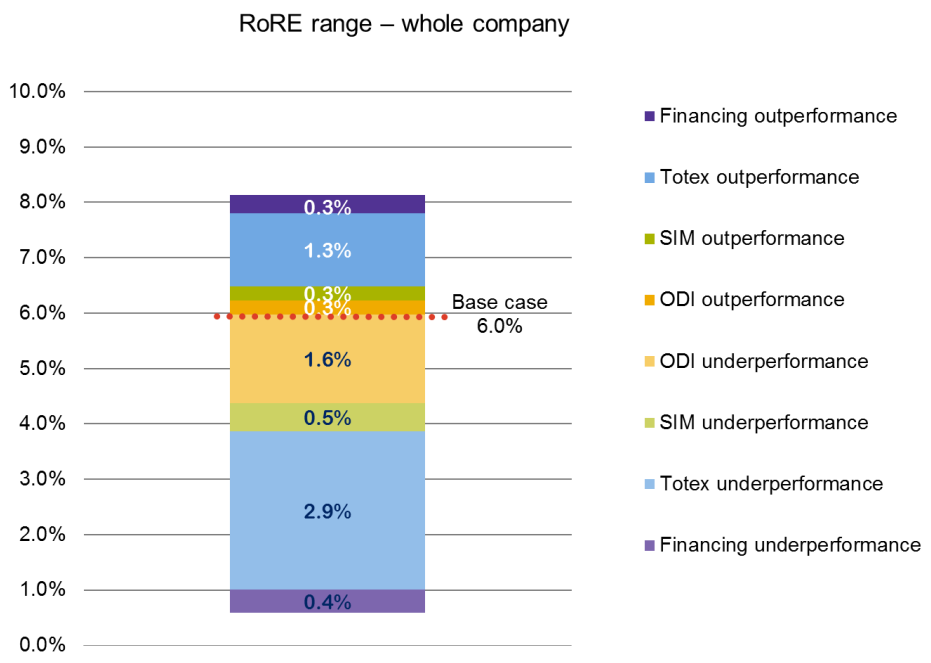
The ODI range proposed by Sutton & East Surrey Water was from -1.2% to +0.8%. We have adjusted this range to -1.6% to +0.3% to take account of our interventions discussed in annex 4.

Sutton & East Surrey Water has assessed financing impacts using a scenario of ±50 basis points on the cost of new debt. We consider the resulting RoRE impact of -0.4% to +0.3% to be reasonable.

SIM impacts have been estimated by Sutton & East Surrey Water using an assumption of maximum rewards and penalties (+6% to -12% of household retail revenue). We consider this to be appropriate.

The composition of the RoRE range for Sutton & East Surrey Water at an appointee level is shown in figure A5.1 below.

Figure A5.1 Sutton & East Surrey Water RoRE range – appointee



Source:

Ofwat calculations based on information from Sutton & East Surrey Water.

A5.4 Financeability

We have compared the financial ratios provided by Sutton & East Surrey Water and our calculation of its financial ratios implied by the company's business plan proposals submitted on 27 June, when both are prepared on a notional basis. We illustrate these in table A5.4 below. The final column of table A5.4 sets out the financeability ratios based on our draft determination revenues and costs.

Table A5.4 Company and Ofwat notional financial ratio calculations based on the company business plan and notional financial ratios based on our draft determination

Financial ratios for notional company	Financial ratio calculations based on the company business plan (average 2015-20)		Financial ratio calculations based on our draft determination (average 2015-20)
	Company calculation	Ofwat calculation	
Cash interest cover (ICR)	3.13	3.42	3.47
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.47	1.35	1.22
Funds from operations(FFO)/debt	16.29%	12.28%	11.62%
Retained cash flow/debt	16.09%	9.30%	8.95%
Gearing	64.88%	64.36%	64.52%
Dividend cover (profit after tax/dividends paid)	1.88	2.09	2.11
Regulatory equity/regulated earnings for the regulated company	16.58	14.87	16.84
RCV/EBITDA	8.02	8.81	9.36

Commentary

Financial ratios: Sutton & East Surrey Water is targeting a credit rating of BBB+. Sutton & East Surrey Water has provided assurance on an actual and notional basis. Our calculated FFO/debt and AICR are lower than the companies due to errors in the company's FFO calculations which do not appear to take appropriate account of pension deficit repair costs or tax. Our draft determinations result in a fall in ratios and the AICR in particular appears low. However, in the round and taking account of the comfortable FFO/debt ratio, we consider that Sutton & East Surrey Water is financeable for draft determination.

Use of PAYG: Sutton & East Surrey Water has increased PAYG since December, partly to shift the recovery of IRE to be recovered in PAYG rather than the RCV run-off and partly to increase revenue in period. Sutton & East Surrey Water PAYG equals to 89% of opex plus IRE and 99% of opex plus IRE expensed. Sutton and East Surrey does not appear to be passing any of the WACC reduction (4.75% to 4.20%) through to customers in terms of

lower bills in 2015-20.

Conclusion on intervention: Given the issues on Sutton & East Surrey Water's calculation of its ratios and the low level of the AICR in particular, Sutton & East Surrey Water should provide us with Board and third party assurance that it is financeable on a notional basis. It may also wish to consider the use of PAYG ratio or RCV run off to bring forward revenue to the 2015-20 period to improve financeability, although it should engage with its customers on any change and explain the benefits to customers of any improvement in financeability ratios. Any engagement on financeability should be undertaken on the basis of notional financeability.

Table A5.5 sets out the PAYG and RCV run-off rates which shows whether revenue has been brought forward compared to the December plan and the impact that this has on RCV growth and longer term affordability and financeability. The PAYG rate has increased but RCV run off has decreased reflecting the shift in recovery of IRE expenses.

Table A5.5 Impact on the longer term

	PAYG rate	RCV run-off	RCV growth % 1 April 2015 to 31 March 2020
Company December plan	54.3%	8.50%	11.4%
Company June plan	60.5%	7.54%	10.5%
Draft determination	60.5%	7.54%	9.4%

A5.5 Affordability

Table A5.6 sets out the change in household bill profile between the company's December and June business plans and the draft determinations.

Table A5.6 Household bill profile

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Company December plan	176	183	177	175	172	168
Company June plan	179	187	181	179	176	171
Ofwat calculation for June plan	176	188	182	182	179	175
Ofwat calculation for draft determinations	176	180	173	169	165	160

Companies have not necessarily used the same method of calculating household bills as Ofwat – for example, we have included economies of scope for household retail when calculating combined water and sewerage bills. So the Ofwat calculations (lines 3 and 4 of table A5.6) are not directly comparable to the company plans (lines 1 and 2 of table A5.6). We have not reprofiled bills as the bill profile for the draft determinations is similar to the profile proposed by the company in its June submission.

Table A5.7 sets out the reasons why this draft determination is assessed as affordable.

Table A5.7 Business plan affordability assessment

	Commentary
Acceptability	Sutton & East Surrey Water's customer engagement, carried out in support of its December submission, found that the business plan was considered acceptable by 84% of customers. However, in the RBR recommendation, we fed back that we were not convinced the impact of the Thames Tideway had been effectively incorporated into the company's research. For this reason, criteria 13.1 was scored as 'more evidence required (C) in the RBR. The company re-ran its research for the June submission, taking our comments into account. The research found that overall acceptability of its plan was now 79%, made up of 77% acceptability for Thames Water customers and 90% acceptability for Southern Water customers..

	Commentary
Identification of affordability issues and appropriate support measures	For its December submission, the RBR concluded that the company had proposed an appropriate range of measures designed to help those customers identified as having affordability problems, including: a proactive metering programme; flexible payment options/debt management; and, water efficiency initiatives. In the revised submission there is no indication that there has been any reduction in scale or scope of the company's affordability measures. And, in fact, the company is planning to bring forward the implementation of the pilot of its social tariff scheme by a year, and will be funding this itself. Given the impact of the Thames Tideway Tunnel on Sutton & East Surrey Water's customers, we would expect the company to establish an ongoing communications programme, including engaging with Thames Water, in order to inform customers of the effects of the Thames Tideway on their bills. It is not clear, from the evidence presented in the business plan, whether the company is intending to do this.
Longer-term affordability – cost Recovery tools	In its December plan, the company demonstrated a robust approach to ensuring that its proposals were affordable to customers in the longer term. The CCG supported the company's use of PAYG adjustments as part of a range of measures designed to deliver flat bills without a reduction in the service provided. In its June plan, the company increased its 2015-20 PAYG ratio in order to maintain financeability in light of the lower WACC resulting from the revised risk and reward guidance. The CCG did not explicitly comment on the company's amendments to its cost recovery tools. Given the lack of engagement with its customers on pass-through of the WACC, we ask Sutton & East Surrey Water to engage with its customer on any changes to proposed PAYG in response to draft determination, in particular on balancing financeability and affordability..
Longer-term affordability – ODIs	The company has presented sufficient evidence that it has revisited its package of ODI measures in accordance with the new guidance, and has also conducted research into customers' acceptability of the ODI package. The CCG confirms that, having been given sight of this research, it supports the conclusion that customers accept the concept of performance related bill impacts.

Annex 1 Wholesale costs

Establishing draft determination thresholds

Our approach to establishing draft determination thresholds is outlined in the wholesale water and wastewater technical appendix.

In the tables below, we provide some information on the company-specific numbers that support these calculations.

Further information about our assessment of each claim is set out in the populated version of draft determination initial cost threshold models.

Table AA1.1 Movement from basic cost threshold to draft determination menu threshold for wholesale water totex (£ million)

Basic cost threshold	Policy additions[1]	Unmodelled costs adjustment	Deep dive	Draft determination threshold	Deep dives fully or partially not added[2]
185.3	19.5	-2.3	25.0	**227.4**	0

Notes:

1. See table AA1.2 below.
2. Deep dives are net of implicit allowances. A value of zero means deep dives are wholly covered by IAs.

Table AA1.2 Policy additions to the wholesale water basic cost threshold (£ million)

Business rates	Pension deficit payments	Third party costs	Open market costs[1]	Net v gross adjustments	Total
12.4	0.2	6.7	0.2	0.0	**19.5**

Note:

1. Of this amount, £0.029 million relates to 2014-15 open market costs.

Table AA1.3 Comparison of company wholesale water totex with the draft determination threshold and 2010-15 totex (£ million)

Plan	DD threshold	Gap[1]	Plan v 2010-15
234.4	227.4	7.0	14.4

Note:

1. This gap will not equal the deep dives fully or partially not added in table AA1.1 if the company's claims for special treatment in the costs thresholds are not equal to the gap.

Table AA1.4 Summary of wholesale water deep dive assessments[1]

Company proposal		Assessment				DD allowance	
Claim	Amount sought	Implicit allowance	Need	CBA	Robust costs	Assessment	Amount allowed
Water softening	24.6	0.0	Pass	Partial Pass	Pass	Partially accept	23.0
Average pumping head[2]	5.3	2.7	Pass	n/a	Partial Pass	Partially accept	2.0
Street works costs	2.1	2.1	n/a	n/a	n/a	Reject	0.0

Note:

1. The company has also made representations on our approach to modelling. Our analysis and conclusions on these matters claim have been set out in annex 1 to the wholesale water and wastewater technical appendix.
2. This adjustment has been made to the underlying models that calculate the basic cost threshold and so is not reflected as a deep dive in table AA1.1.

Annex 2 Household retail revenue modification

We outline our approach to revenue modification in the household retail price control in the household retail technical appendix.

Table AA2.1 sets out the amount per customer, by customer type, that allowed revenues will be modified by if out-turn customer numbers differ from forecast customer numbers and table AA2.2 sets out the baseline number of customers.

Table AA2.1 Household retail allowed revenue modification factors by class of customer (£/customer)

Revenue modification per:	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only customer	14.27	13.86	14.39	14.02	13.43
Metered water only customer	27.85	25.20	23.44	20.82	20.25

Note:

There will be no indexation for retail price controls.

Table AA2.2 Assumed number of customers for household retail total revenues (000s)

Number of customers	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only	135.469	129.014	122.624	116.298	110.035
Metered water only	130.513	139.372	148.142	156.926	165.650

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Annex 3 Reconciling 2010-15 performance

We set out our methodology for calculating the adjustments to 2015-20 wholesale price controls resulting from the company's actual performance during the 2010-15 period in the wholesale water and wastewater technical appendix.

In this annex, we set out the draft determination adjustments to 2015-20 price controls for Sutton & East Surrey Water resulting from the company's actual performance during the 2010-15 period.

As part of the draft determination of the 2010-15 adjustments we have undertaken detailed calculations within our models for the RCM, OIA, CIS and serviceability shortfalls. While we have covered an explanation of our interventions within this annex, each model covers the detail of the specific calculation. Similarly, our detailed calculations behind the midnight adjustments such as land sales (but excluding those relating to the Change protocol) are contained within the RCV midnight adjustment model. A copy of any of these models is available on request.

Table AA3.1 below compares the company's view of the required revenue adjustments included in its revised business plan for each of the incentive tools for water services, with our own view. Our view reflects our understanding of the company's performance using these incentives, based on information provided in its revised business plan and subsequent query responses. The table also shows other adjustments, such as those relating to tax resulting from the company's actual performance during the 2010-15 period.

Table AA3.1 Revenue adjustments 2015-20 (£ million)

	Company view	Ofwat view
Service incentive mechanism (SIM)	0.000	0.289
Revenue correction mechanism (RCM)	9.535	9.277
Opex incentive allowance – post-tax (OIA)	1.488	1.488
Capital expenditure incentive scheme (CIS)	-3.410	-3.614
Tax refinancing benefit clawback	0.000	0.000
Other tax adjustments	0.000	0.000
Equity injection clawback	0.000	0.000
Other adjustments	0.000	0.000
Total wholesale legacy adjustments	7.613	7.440

Notes:

Totals may not add up due to rounding.

For the CIS mechanism, there is a corresponding adjustment to the RCV made at 1 April 2015 (part of the 'midnight' adjustments'). The impact on the RCV for water can be seen in table AA3.17. This adjustment is net of any logging up, logging down or shortfalls. A full reconciliation showing all of the midnight adjustments to the RCV, including the impact of logging up, logging down and shortfalls, can be seen in table A2.5.

We noted that the company revised business plan table W20 has profiled values while using an early version of the CIS model that does not contain the profiling functionality. The company states it has profiled the revenue adjustment using option 1 (constant annuity option) however the sum of the annual values entered in table W20 equals the single year adjustment.

Service incentive mechanism (SIM)

We provide our view of each company's SIM reward/penalty in the wholesale water and wastewater technical appendix.

Table AA3.2 provides the annualised rewards from the company's SIM performance. The difference of views reflects that the reward calculation has used updated industry performance statistics.

Table AA3.2 SIM annualised rewards (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	0	0	0	0	0	0
Ofwat view	0.058	0.058	0.058	0.058	0.058	0.289

Revenue correction mechanism (RCM)

This draft determination includes our view of the company's RCM annualised adjustment amounts as detailed in table AA3.3 below. Table AA3.4 summarises our interventions in relation to Sutton & East Surrey Water's proposed 2010-15 RCM adjustments.

Table AA3.3 RCM annualised adjustments for 2015-20 (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	1.907	1.907	1.907	1.907	1.907	9.535
Ofwat view	1.855	1.855	1.855	1.855	1.855	9.277

Table AA3.4 Interventions on proposed 2010-15 RCM adjustments

Area of intervention	What we did	Why we did it
Forecast 2014-15 tariff basket revenue	We have restricted the revenue shortfall in 2014-15 to the level recorded in 2013-14.	The company did not explain the reasons for a widening difference between its 2014-15 forecasted revenue and its FD09 revenues forecast compared to previous years variances seen in 2013-14 and earlier years.
Number of households billed	Our assumptions for the draft determination uses the data the company submitted in business plan table R3 to calculate our view of the RCM adjustment.	There were inconsistencies with the number households billed between business plan table R3 and the company's populated RCM model.
FD09 assumptions	Our assumptions at the draft determination includes our view of the FD09 assumptions.	There are inconsistencies between the company's and our view of the FD09 assumptions used in the company's populated RCM model.
Out-turn financial year average RPI	Our assumptions for the out-turn financial year average RPI at the draft determination uses the data that the company has submitted in business plan table A9 to calculate our view of the RCM adjustment.	There are inconsistencies with the out-turn financial year average RPI between table A9 and the company's populated RCM model.
PR14 discount rate	Our assumptions for the PR14 discount rate at draft determination is 3.7% for all companies to calculate our view of the RCM adjustment.	The company proposed a PR14 discount rate of 5%. Our assumptions for the PR14 discount rate at DD is 3.7%.

Area of intervention	What we did	Why we did it
Corporation tax rate	Our assumptions for the corporation tax rate applied in the RCM model at the draft determination is the same as HMRC's published tax rates for each year.	The company has applied a corporation tax rate of 28% across all years in its populated RCM model. Our assumptions for the corporation tax rate applied in the RCM model at the draft determination is the same as HMRC's published tax rates for each year.

Operating expenditure incentive allowance (OIA)

Table AA3.5 below summarises the company's view and our view of the incentive allowances for 2015-20. Table AA3.6 summarises our interventions in relation to Sutton & East Surrey Water's proposed 2010-15 OIA adjustments.

Table AA3.5 Operating expenditure incentive allowances for 2015-20 (£ million)

Water service		2015-16	2016-17	2017-18	2018-19	2019-20	Total
Incentive allowance (post-tax)	Company view	0.000	1.488	0.000	0.000	0.000	1.488
	Ofwat view	0.298	0.298	0.298	0.298	0.298	1.488

Table AA3.6 Interventions on proposed 2010-15 OIA adjustments

Area of intervention	What we did	Why we did it
There are no interventions in this area.	n/a	n/a

Change protocol (logging up, logging down and shortfalls)

Tables AA3.7 and AA3.8 below summarise Sutton & East Surrey Water's view and our baseline view that no adjustments are required for:

- capex included in the CIS reconciliation; and
- the FD09 opex assumptions used in the calculation of the opex incentive revenue allowances.

Table AA3.9 confirms that we do not propose any interventions in relation to Sutton & East Surrey Water's proposed change protocol adjustments.

Table AA3.7 Summary of post-efficiency capex for logging up, logging down and shortfalls included in the CIS reconciliation (£ million)

2009-10 to 2014-15 – post-efficiency capex	Company view	Ofwat view
Logging up (two sided)	0.000	0.000
Logging down (two sided)	0.000	0.000
Shortfalls (one sided)	0.000	0.000

Notes:

1. Includes two-sided adjustments from the PR09 agreed overlap programme as set out in table AA3.13.
2. We exclude shortfalls for serviceability from the CIS reconciliation, but instead make direct adjustments to the RCV in 2015-16. We do this to allow the actual capex the company incurred in seeking to maintain serviceability, to be reflected in the rewards or penalties earned through the scheme. But to also ensure customers are not required to pay for the regulatory output the company has failed to deliver.

Table AA3.8 Summary of post-efficiency opex for logging up, logging down and shortfalls included in the opex incentive allowance calculation (£ million)

2009-10 to 2014-15 – post-efficiency opex	Company view	Ofwat view
Logging up	0.000	0.000
Logging down	0.000	0.000
Shortfalls	0.000	0.000
Shortfalls for serviceability	0.000	0.000

Table AA3.9 Interventions on proposed 2010-15 change protocol adjustments

Area of intervention	What we did	Why we did it
There are no interventions in this area.	n/a	n/a

Service standard outputs

The final determination supplementary reports in 2009 contained defined project(s) where the primary output was the service standard specified[1]. These outputs were set out to recognise that companies may decide to prioritise investment differently in order to achieve the service output in a more innovative and efficient manner, while still holding the company to account for the benefits to customers and the environment.

Where companies have not reported progress on these service standards, we would have expected them to demonstrate achievement of the service standards to both customers and Ofwat as part of the price review process.

[1] In the final determination supplementary reports we said: "Both the project activity (as proposed in your final business plan) and the service standard are the defined output. You must demonstrate delivery of the stated service standard output through the June return. The service standard output is the primary output. We recognise that companies may decide to prioritise activity differently in order to achieve the service output in a more efficient manner. All material changes to the project activity must be reported and explained through your June return."

We have considered applying shortfalls equal to the cost of the FD09 project(s) with defined service standards. However, in many cases there is some evidence that the projects and activities have been delivered, but there is a lack of compelling evidence that the service standards specified have been achieved.

For the purposes of these draft determinations, we will not applying shortfalls on this issue conditional upon this information being provided as part of companies' draft determination representations. We would expect companies to respond to this issue in their representations. If they do not provide adequate evidence to demonstrate achievement of the service standards set out, then they should assume that we will apply a shortfall equal to the costs assumed for the project(s) at FD09 within our final determinations in December 2014.

Serviceability performance

Table AA3.10 below summarises our serviceability assessments for Sutton & East Surrey Water and table AA3.11 quantifies the value and impact of any serviceability shortfall on the RCV. Table AA3.12 summarises our interventions in relation to Sutton & East Surrey Water's proposed adjustments for serviceability.

Table AA3.10 Serviceability assessments for 2010-15

		2010-11	2011-12	2012-13	2013-14	2014-15[2]
Water infrastructure	Company view	Stable	Stable	Stable	Stable	Stable
	Ofwat view	Stable	Stable	Stable	Stable	Stable
Water non infrastructure	Company view	Stable	Stable	Stable	Stable	Stable
	Ofwat view	Stable	Stable	Stable	Stable	Stable

Notes:

1. Assessments are based on actual and forecast performance submitted in the company's revised business plans.
2. Assessments for 2014-15 are based on forecast data and are subject to review once actual performance data becomes available.

Table AA3.11 Impact of serviceability shortfalls on the RCV (£ million)

2009-10 to 2014-15		Water service
Amount subtracted from RCV	Company view	0.0
	Ofwat view	0.0

Table AA3.12 Interventions on proposed 2010-15 serviceability adjustments

Area of intervention	What we did	Why we did it
There are no interventions in this area.	n/a	n/a

The 2009 agreed overlap programme

As the company did not propose an overlap programme at PR09, our FD09 did not contain any agreed projects that would need to be reviewed in this price review. Therefore, we have not assessed any scheme progress or costs under this mechanism. Table AA3.14 confirms this position and table AA3.13 below confirms the zero assumptions included in this draft determination.

Table AA3.13 PR09 agreed overlap programme adjustments and assumptions (£ million)

	2010-15		2015-20	
	Two-sided adjustment for inclusion in the CIS		Expenditure forecasts to complete the projects	
	Capex	Opex	Capex	Opex
Company view	0.000	0.000	0.000	0.000
Ofwat view	0.000	0.000	0.000	0.000

Table AA3.14 Interventions on proposed 2010-15 PR09 agreed overlap programme adjustments

Area of intervention	What we did	Why we did it
The company did not propose an overlap programme at PR09.	n/a	n/a

The 2014-15 transition programme

Table AA3.15 below confirms that did not propose a transition programme and table AA3.16 confirms that we have not made any intervention in relation to Sutton & East Surrey Water's proposal.

Table AA3.15 Transition programme in 2014-15

Net capital expenditure	2014-15 (£ million)	Proportion of forecast in 2014-15	Proportion of capital programme in 2015-20
Water service	0.000	0.00%	0.00%

Table AA3.16 Interventions on proposed transition programme

Capex scheme	What we did	Why we did it
The company did not propose a transition programme.	n/a	n/a

Capital expenditure incentive scheme (CIS)

Table AA3.17 provides details of the CIS ratios and performance incentive. It also gives the:

- monetary amounts of the CIS performance reward or penalty;
- true-up adjustment to 2015-20 allowed revenues; and
- midnight adjustment to the closing 2014-15 RCV.

Table AA3.18 then sets out the profiled values of the revenue adjustments in each year 2015-20.

Table AA3.17 Legacy true-up adjustments

		Water service
Restated FD09 CIS bid ratio	Company view	123.560
	Ofwat view	123.561
Out-turn CIS ratio	Company view	105.277
	Ofwat view	105.055
Incentive reward/penalty (%)	Company view	-2.349
	Ofwat view	-2.309
Reward/penalty (£m)	Company view	-2.324
	Ofwat view	-2.291
Adjustments to 2015-20 revenue (£m)	Company view	-3.408
	Ofwat view	-3.365
CIS adjustment to RCV (£m)	Company view	-6.540
	Ofwat view	-6.525

Commentary

The company has broadly applied the published Ofwat methodology. However:

- the company has submitted an early version of the CIS model (v2) that does not contain the profiling functionality;
- the company states it has profiled the revenue adjustment using option 1 (constant annuity option) however the sum of the annual values entered in table W20 equal the single year adjustment; and

	Water service

- RPI details in the company's CIS model are inconsistent with submitted table A9.

In carrying out our assessment we have:

- used the values submitted in table A9 in the CIS model;
- profiled the revenue adjustment as an annual annuity; and
- used our assumption of the cost of capital (3.70%) as the discount rate when profiling the revenue adjustment.

Notes:

The restated FD09 CIS bid ratio takes account of the adjustments for the change protocol (table AA3.7) and the 2009 agreed overlap programme (table AA3.13).

The reward/(penalty) is adjusted for the additional income included in the 2010-15 determination and the financing cost on the difference between actual spend and capital expenditure assumed in the 2010-15 determination to derive the value of the adjustment to 2015-20 revenue.

The adjustment to 2015-20 revenue values shown in this table assume a single year adjustment in the first year, and do not include the NPV profiling used for the draft determination.

Table AA3.18 Profiled revenue adjustments from the CIS reconciliation (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-3.408	0.000	0.000	0.000	0.000	-3.408
Ofwat view	-0.723	-0.723	-0.723	-0.723	-0.723	-3.614

Note:

The company states it has profiled the revenue adjustment using option 1 (constant annuity option) however the sum of the annual values submitted in table W20 equal the single year adjustment so we show a single year adjustment for the company view in table AA3.18.

Other adjustments

Table AA3.19 below confirms the assumptions included in this draft determination with respect to the following adjustments:

- tax refinancing benefit clawback;
- other tax adjustments;
- equity injection clawback; and
- other adjustments.

Table AA3.19 Other adjustments 2015-20 (£ million)

	Company view	Ofwat view	Commentary
Tax refinancing benefit clawback	0.000	0.000	No adjustment was proposed by the company
Other tax adjustments	0.000	0.000	No adjustment was proposed by the company
Equity injection clawback	0.000	0.000	No adjustment was proposed by the company
Other adjustments	0.000	0.000	No adjustment was proposed by the company

Annex 4 Outcomes, performance commitments and outcome delivery incentives

This chapter sets out in detail the performance commitments and outcome delivery incentives (ODIs) we are proposing for the company's wholesale water and household retail outcomes, presented in that order.

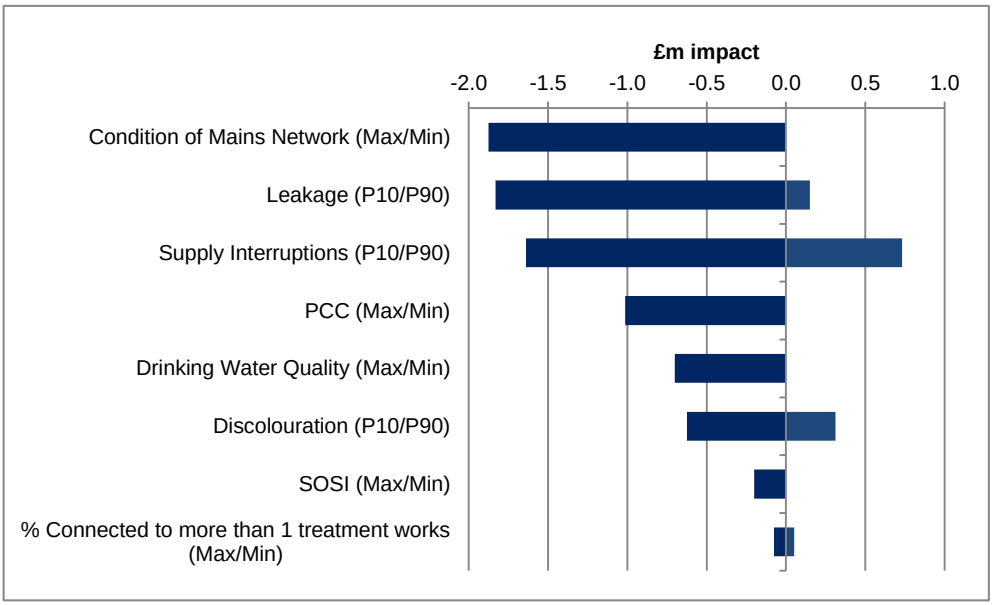
The two figures below first provide an overview of these proposed performance commitments and ODIs. Figure AA4.1 shows the balance between reward and penalty, penalty only and reputational incentives in the package of proposed incentives for the company and figure AA4.2 shows the potential financial impact of each of the financial incentives proposed.

Figure AA4.1 The composition of the proposed package of ODIs

	Reward and Penalty	Penalty Only	Non-financial
Wholesale water	5	4	6
Household retail	0	0	5
Total	5	4	11

The following graph shows the potential financial consequences of the individual financial ODIs. The figures represent the penalties and rewards associated with the P10 and P90 scenarios over the five years (2015-16 to 2019-20). This means there is a 10% chance of performance being higher or lower than these assumed levels. In most cases the potential maximum will be bigger but is very unlikely to occur. The P10 and P90 scenarios therefore represent a more realistic estimate of potential financial impacts.

Figure AA4.2 Overview of financial ODIs



Tables AA4.1 and AA4.2 set out a more detailed explanation of our interventions in the company's wholesale water and household retail outcomes.

As explained in the outcomes technical appendix, we are proposing the introduction of an aggregate cap on rewards and collar on penalties from the outcome delivery incentives. Details of how the cap/collar will operate are set out in section A5 of the outcomes technical appendix.

Table AA4.1 Summary of interventions on wholesale water outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
A1 SOSI (Security of Supply Index) dry year average	Introduce a penalty only incentive, with deadband and collar	We are introducing a penalty only incentive as the company could not demonstrate that the non-financial incentive sufficiently protected customers for under or poor performance.
A3 Supply interruptions	Adjusted PC level for 2017-18 onwards and change penalty and reward deadbands, caps and collars	We have intervened following a review of supply interruptions across all companies to ensure that the company **are incentivised to achieve upper quartile performance**. The interventions for this PC and incentive are a result of a horizontal comparison

PC/ODI affected	What we did	Why we did it
		across the industry, and will ensure that the company is incentivised to deliver upper quartile performance by 2017-18. We have changed the deadbands to ensure that the company has a glide path to deliver upper quartile performance, with appropriate penalties for under or poor performance and application of rewards for genuine outperformance.
A4 Condition of mains network	Tighten the performance deadband	In response to the query process on the June submission, the company introduced a penalty incentive on the PC. We are intervening to tighten the penalty deadband to ensure that penalties apply over an effective range.
A5 Drinking Water Inspectorates Index of Water Quality	Adjusted the penalty deadbands and collars	The company has defined outcome delivery incentives for drinking water quality compliance with a penalty at less than 100%. This penalty represents an incentive to the company to not reduce its compliance with water quality measures. This threshold represents the point at which financial incentives will be applied to the company through the price setting process. All companies are subject to drinking water quality obligations regulated by the DWI, which are the overriding statutory obligations that a water company must comply with as part of their section 37 obligations. The company's Board has confirmed as part of its business plan submission that it will comply with all relevant statutory obligations. We have intervened on the ODI following a review of drinking water quality across all companies to ensure that the company **are incentivised to achieve upper quartile performance**. The interventions for this PC and incentive are a result of a horizontal comparison across the industry, and will ensure that the company is incentivised to deliver upper quartile performance by 2017-18. We have changed the deadbands to

PC/ODI affected	What we did	Why we did it
		ensure that the company has a glide path to deliver upper quartile performance, with appropriate penalties for under or poor performance. We have removed the penalty cap which limited penalties to one year in the five year period to ensure that customers are protected from under-performance in all years.
C2 Percentage of properties that are connected to more than one treatment works	Reduced reward rate	The reward rate has been adjusted to ensure that customers are protected and the company is encouraged to improve efficiency as well as increased scope.
E1 Levels of leakage measured in litres per day	Increased the range over which the penalty applies	The intervention to increase the range over which a penalty applies in each year ensures that customers are protected from under or poor performance.
E2 Per capita consumption in litres per day	Removed the reward incentive	The reward has been removed from the ODI as the use of the reward rate has not been sufficiently justified by the company and there was also a lack of evidence of stretching performance.

Table AA4.2 Summary of interventions on household retail outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
We have not made any interventions.		

Outcome delivery and reporting

In the outcomes technical appendix, we outline a framework against which we have assessed Sutton & East Surrey Water's proposals in relation to outcome delivery and reporting.

The table below summarises Sutton & East Surrey Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach.

Table A2.10 Sutton & East Surrey Water's proposals for outcome delivery and reporting

Sutton & East Surrey Water proposals	Our assessment
In the June submission, the company set out the measurement, recording and governance for performance commitments and outcomes. For each performance commitment, the company has outlined the internal department responsible for undertaking the measurement and the assurance and audit provisions (such as an annual external audit, reported to the Board). Performance data will be collected through the existing procedures, previously established for the former June Return process. The company proposes to report the performance commitments within the existing Annual Report, as well as through the Annual Stakeholder event and will publish annual results on their website. The company is proposing to retain a Reporter, as well as external Auditor to provide assurance certificates in the Annual Report. The company commits to providing access to the external audit results to the CCG, and for relevant performance commitments, the DWI and the Environment Agency. Additionally the company commits to holding one or more customer workshops per annum at which performance will be reported.	In our methodology statement we set out our expectation that companies should demonstrate that their proposed PCs can be measured and recorded consistently and that they will have the appropriate governance and quality assurance processes in place to achieve this. We also expect companies to be transparent with customers about their performance against their outcomes and commitments. Sutton & East Surrey Water has provided sufficient evidence demonstrating the approach it will undertake to ensure the PCs will be measured and reported consistently, and the proposed governance and assurance processes. Therefore, we have accepted the company's proposal. In time, we may develop further information requirements with regard to outcomes, as we review and change current requirements relating to performance indicators and each company's annual risk and compliance.

In the remainder of this section, we provide the following information on each performance commitment we are proposing as part of this draft determination.

- The name and detailed definition of the performance commitment.

- The type of incentive.
- The performance commitment level.
- For financial incentives:
  - the limits on rewards and penalties (caps and collars) and neutral zones (deadbands) as applicable[3]; and
  - the incentive rates.
- Additional details on the measure.
- Where Ofwat has not accepted the company's proposals, the nature of the intervention made is also explained.

Appendix 1 of our final methodology statement contains a number of worked examples that illustrate how the different incentive types will operate.

We have intervened in relation to a number of performance commitments proposed by the company. Where our intervention is to remove the performance commitment in question, details and reasoning are provided in table AA4.1 at the end of this annex. Where we have amended the company's proposed incentive but retained the performance commitment, we have intentionally set out our interventions below using a ~~strikethrough~~. What this means is that we have rejected the proposal that has been struck through and instead we have either used a different value or not included a value at all (for example, in the case of some rewards).

Sutton & East Surrey Water will be able to finalise its proposed menu choice and affected ODI calibrations following our consideration of responses to these proposals.

Table AA4.5 Performance commitments proposed by the company that we have removed from this draft determination

Performance commitment	Reason for its removal
We have not removed any performance commitments	

[3] In general, the cap or collar is the level of service at which the maximum penalty or reward occurs and a deadband is the level of service at which the incentive first applies. However, where a greater than or less than symbol precedes the figure this denotes that the maximum or initial incentive only occurs if service is greater than or less than this level.

Table AA4.6 Performance commitments that we have added to this draft determination

Performance commitment	Reason for its addition
We have not added any performance commitments	

Wholesale water outcome A: Providing a reliable and sufficient supply of safe, high quality drinking water

Performance commitment A1: Security of supply index (SoSI) dry year average

Detailed definition of performance measure: A SoSI of 100 means the company has sufficient resource to meet demand (including target headroom) in a dry year.

Incentive type: ~~Reputational.~~ Penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
SoSI (dry year average)	Nr	100	100	100	100	100	100
Penalty collar	Nr		1 breach of deadband over the 5yr period				
Penalty deadband	Nr		98	98	98	98	98

Incentive rates

Incentive type	Performance levels (Nr)		Incentive rate (£m/Nr/)
	Lower	Upper	
Penalty	<98	98	£0.2

Additional details

Necessary detail on measurement units	For SOSI methodology refer to June Return reporting requirements and definitions manual 2011, Section 2, Chapter 10a.
Frequency of PC measurement and any use of averaging	Annual

Timing and frequency of penalties	Annual calculation paid 5 yearly as part of a basket of rewards and penalties
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	The penalty is capped at one failure over the deadband for the five-year period. The incentive rate is based on the capital expenditure for enhancements to the supply demand balance (dry year average annual conditions) for the period, calibrated for the totex incentive. The company operates within the levels of service set out in its Water Resources Management Plan. These are: • a ban on the use of hosepipes and unattended watering devices (temporary use restrictions) occurs no more than once every ten years on average; • the company will implement a drought order to restrict the non-essential use of water no more than once every 20 years on average; and • Emergency Drought Order measures (eg rota cuts, use of standpipes and phased pressure management) will only be required in the most extreme droughts or emergency situations.

Performance commitment A2: Security of supply index (SoSI) critical period

Detailed definition of performance measure: A SoSI of 100 means the company has sufficient resource to meet demand (including target headroom) in a peak week.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
SoSI (critical period)	Nr	100	100	100	100	100	100

Additional details

Necessary detail on measurement units	For SOSI methodology refer to June Return reporting requirements and definitions manual 2011, Section 2, Chapter 10a.
Frequency of PC measurement and any use of averaging	Annual
Any other information or clarifications relevant to correct application of incentive	The company operates within the levels of service set out in its Water Resources Management Plan. These are: • a ban on the use of hosepipes and unattended watering devices (temporary use restrictions) occurs no more than once every ten years on average; • the company will implement a drought order to restrict the non-essential use of water no more than once every 20 years on average; and • emergency drought order measures (eg, rota cuts, use of standpipes and phased pressure management) will only be required in the most extreme droughts or emergency situations.

Performance commitment A3: Supply interruptions

Detailed definition of performance measure: The total number of hours that properties are affected by supply interruptions greater than three hours, per total number of billed properties. This is regardless of whether the interruption is planned or unplanned.

Incentive type: Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Hrs/prop	0.29	~~0.30~~ 0.25	~~0.30~~ 0.21	~~0.30~~ 0.17	~~0.30~~ 0.17	~~0.30~~ 0.17
Penalty collar	Hrs/prop		~~0.55~~ 0.46	~~0.55~~ 0.46	~~0.55~~ 0.33	~~0.55~~ 0.33	~~0.55~~ 0.33
Penalty deadband	Hrs/prop		~~0.4~~ 0.29	~~0.4~~ 0.29	~~0.4~~ 0.17	~~0.4~~ 0.17	~~0.4~~ 0.17
Reward deadband	Hrs/prop		~~0.2~~ 0.17	~~0.2~~ 0.17	~~0.2~~ 0.17	~~0.2~~ 0.17	~~0.2~~ 0.17
Reward cap	Hrs/prop		~~0.1~~ 0	~~0.1~~ 0	~~0.1~~ 0	~~0.1~~ 0	~~0.1~~ 0

Incentive rates

Incentive type	Performance levels (Hrs /prop)		Incentive rate (£m/hour/prop/year)
	Lower	Upper	
Penalty	~~0.4~~ 0.17	~~0.55~~ ~~0.~~46	2.0000
Reward	~~0.1~~ 0	~~0.2~~ 0.17	2.000

Additional details

Necessary detail on measurement units	The total number of billed properties without water for more than three hours divided by the total time of interruption (in hours) divided by the total number of billed properties at year end.
Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of rewards/penalties	Annual calculation paid five-yearly as part of a basket of rewards and penalties.
Form of reward/penalty	Adjustment to revenue.

Any other information or clarifications relevant to correct application of incentive	None

Performance commitment A4: Condition and reliability of the mains network

Detailed definition of performance measure: Number of burst pipes per annum.

Incentive type: Penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of burst pipes	Nr/ year	227	290	290	290	290	290
Penalty collar	Nr/ year		470	470	470	470	470
Penalty deadband	Nr/ year		345 ~~390~~	345 ~~390~~	345 ~~390~~	345 ~~390~~	345 ~~390~~

Incentive rates

Incentive type	Performance levels (Nr/Yr)		Incentive rate (£m/Nr/Yr)
	Lower	Upper	
Penalty	345 ~~390~~	470	0.003

Additional details

Necessary detail on measurement units	For definition of a burst refer to June Return reporting requirements and definitions manual 2011, Section 2, Chapter 11, line 12.

Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of penalties	Annual calculation paid five yearly as part of a basket of rewards and penalties.
Form of penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	The measure provides a longer-term indication of the level of service. The company's target is to replace enough pipes to ensure bursts reduce or do not increase.

Performance commitment A5: Drinking Water Inspectorate's Index of Water Quality

Detailed definition of performance measure: Statistical analysis based on a prescribed number of tests on samples of the company's drinking water that have been taken from treatment works, service reservoirs and customers' taps.

Incentive type: Financial – Penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Index of water quality	%	100	100	100	100	100	100
Penalty collar	%		99.93	99.93	99.95	99.95	99.95
Penalty deadband	%		99.94 ~~99.93~~	99.94 ~~99.93~~	99.96 ~~99.93~~	99.96 ~~99.93~~	99.96 ~~99.93~~

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£m/0.01%)
	Lower	Upper	
Penalty	<99.93 ~~<99.94~~	99.96 ~~99.93~~	0.140

Additional details

Necessary detail on measurement units	The methodology for determining the index is published by the Drinking Water Inspectorate.
Frequency of PC measurement and any use of averaging	Annual (based on a calendar year).
Timing and frequency of penalties	Annual calculation, with penalty applied at the end of the five-year period as part of a basket of rewards and penalties.
Form of penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Results are published annually by the Drinking Water Inspectorate. The penalty is applied in a binary manner, any failure to meet the performance commitment incurs the full penalty. ~~It should be noted that the level of 100 is a target not a performance commitment. It would be inappropriate to aim to fail.~~

Performance commitment A6: Taste, odour and discolouration

Detailed definition of performance measure: The number of contacts received about taste, odour and discolouration.

Incentive type: Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Nr	350	350	350	350	350	350
Penalty collar	Nr		500	500	500	500	500
Penalty deadband	Nr		375	375	375	375	375
Reward deadband	Nr		325	325	325	325	325
Reward cap	Nr		200	200	200	200	200

Incentive rates

Incentive type	Performance levels (Nr)		Incentive rate (£m/contact/year)
	Lower	Upper	
Penalty	375	500	0.001
Reward	200 ~~100~~	325	0.0005

Additional details

Necessary detail on measurement units	No further detail required.
Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of rewards/penalties	Annual calculation paid five-yearly as part of a basket of rewards and penalties.
Form of reward/penalty	Adjustment to revenue.

Any other information or clarifications relevant to correct application of incentive	This measure works in combination between the UKWIR criteria and the DWI index measure and between them they capture the relevant issues relating to water quality.

Wholesale water outcome C: Increasing the resilience of our network to drought, flooding and equipment failure

Performance commitment C1: The number of times on average the Company has to impose restrictions on the use of water

Detailed definition of performance measure: The number of times on average that the company has had to impose restrictions on the use of water (a Temporary Use Ban) over the last ten years.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Temporary Use Ban imposed	Times per 10 years	1	1	1	1	1	1

Additional details

Necessary detail on measurement units	None
Frequency of PC measurement and any use of averaging	Annual
Any other information or clarifications relevant to correct application of incentive	None

Performance commitment C2: Percentage of properties that are connected to more than one treatment works

Detailed definition of performance measure: This is a measure of the company's resilience. It is measured by calculating the number of properties that can be supplied from more than one treatment works. The company is aiming to ensure that all properties (100%) can be supplied from more than one treatment works by 2025.

Incentive type: ~~Reputational.~~ Financial – Reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of customers that can be supplied by more than one treatment works	%	36	36	36	36	56	56
Penalty collar	%						51
Reward cap	%						66

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£m/%)
	Lower	Upper	
Penalty	51	56	0.015
Reward	56	66	0.0052 ~~0.0065~~

Additional details

Necessary detail on	None.

measurement units	
Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of penalty and reward	Calculation at the end of the five-year period, with penalty and rewards applied at the end of the five-year period as part of a basket of rewards and penalties.
Form of penalty and reward	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	While this indication of resilience is likely to be relevant in the future, the company may need to develop another measurement of resilience once all properties can be supplied from more than one treatment works.

Wholesale water outcome E: Reducing our impact on the environment while seeking to make a positive contribution to its quality

Performance commitment E1: Level of leakage measured in Megalitres per day

Detailed definition of performance measure: The total level of leakage, including customer supply pipe leakage, expressed in megalitres per day (Ml/day).

Incentive type: Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Ml/d	24.5	24.4	24.3	24.2	24.1	24.0
Penalty collar	Ml/d		27 ~~25~~	27 ~~25~~	27 ~~25~~	27 ~~25~~	27 ~~25~~
Penalty deadband	Ml/d		24.9	24.8	24.7	24.6	24.5
Reward deadband	Ml/d		23.9	23.8	23.7	23.6	23.5
Reward cap	Ml/d		23.4	23.3	23.2	23.1	23

Incentive rates

Incentive type	Performance levels (Ml/d)		Incentive rate (£m/Ml/d)
	Lower	Upper	
Penalty	24.5	27 ~~25~~	0.200
Reward	23 ~~21~~	23.9	0.060

Additional details

Necessary detail on	No further detail required.

measurement units	
Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of rewards/penalties	Annual calculation paid five-yearly as part of a basket of rewards and penalties.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	None.

Performance commitment E2: Per capita consumption (PCC) measured in litres per head per day (l/h/d)

Detailed definition of performance measure: PCC in l/h/d to measure the effect of the company's demand management activities (excluding leakage).

Incentive type: ~~Financial – reward and penalty.~~ Financial – Penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	l/h/d	162.8	161.2	160	158.8	157.7	156.9
Penalty collar	l/h/d		164.3	163.1	161.8	160.7	159.9
Penalty deadband	l/h/d		161.4	160.2	159.0	157.9	157.1
~~Reward deadband~~	~~l/h/d~~		~~161.0~~	~~159.8~~	~~158.6~~	~~157.5~~	~~156.7~~
~~Reward cap~~	~~l/h/d~~		~~158.1~~	~~156.9~~	~~155.8~~	~~154.7~~	~~153.9~~

Incentive rates

Incentive type	Performance levels (l/h/d)	Incentive rate (£m/ l/h/d)

Incentive type	Performance levels (l/h/d)		Incentive rate (£m/ l/h/d)
	Lower	Upper	
Penalty	157.1	164.3	0.0714
~~Reward~~	~~153.9~~	~~156.7~~	~~0.0322~~

Additional details

Necessary detail on measurement units	No further detail required.
Frequency of PC measurement and any use of averaging	Annual.
Timing and frequency of rewards/penalties	Annual calculation paid five-yearly as part of a basket of rewards and penalties.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	The target for the end of the AMP6 period is set at 156.9 l/h/d. There is a glide path for the performance level to improve from the forecast level in 2014-15 to the target level in 2019-20. The target level of PCC corresponds to a metering penetration of 61%. Penalty~~/ reward~~ is calculated by placing a monetary value on the greenhouse gas (GHG) externality – specifically, we consider the benefit / cost from changing GHG emissions associated with water heating. It is noted that PCC varies from year to year due to a variety of factors which are outside the company's control, of which the most significant is the weather. A hot dry summer would push PCC up, while wet weather would have the opposite effect. PCC could range from -5% to +10% due to the effect of weather. Focussing on the specific link between metering and PCC, the company considers it appropriate to focus on variation around the target of ±2%.

Performance commitment E3: The number of children and adults engaged in environmental education activities

Detailed definition of performance measure: The number of pupils receiving a school talk on environmental matters/water efficiency plus the number of consumers attending a water tasting event. This helps present and future customers to understand the impact that their use of water can have on the environment.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of children and adults receiving environmental education from the company	Nr	6221	8000	8500	9000	9500	>10000

Additional details

Necessary detail on measurement units	Records are kept of the number of children and adults the company engages with.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	This is a key part of the company's demand management programme.

Performance commitment E4: Greenhouse gas emissions per million litres of water supplied

Detailed definition of performance measure: Gross operational greenhouse gas emissions per Ml of treated water distribution input in kgCO_2e/Ml.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Gross operational greenhouse emissions per megalitre of treated water distribution input	kgC O_2e/ Ml	529	525	525	525	525	525

Additional details

Necessary detail on measurement units	Calculated using the UKWIR "Workbook for estimating operational GHG emissions".
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	The company will do this by reducing the amount of water it takes from the environment, operating its plants as efficiently as it can and installing more energy efficient equipment Since PR09 the company has gathered five years of operational data. The company appreciates that its electricity usage is the main driver of its GHG emissions and now has a good understanding of the impact of scope 1 and 3 emissions. This means that the company can set itself more accurate targets for the control of GHG emissions in AMP6 than it could in AMP5. Each scope was treated individually and the following was used to determine the emissions target for the company. • Scope 1 – An average value for emissions for the last three years was used. This is independent of distribution input. • Scope 2 – The company's average energy intensity was determined (kWh/ML). This was combined with the company's forecast

	distribution input to determine the volume of electricity required each year. The volume of electricity (kWh/yr) was converted to greenhouse gas emissions using the grid emission factor contained within the UKWIR carbon accounting workbook version 7. This is currently 0.52 kg CO_2 equivalent per kWh of electricity. The company's energy intensity remains constant through the AMP6 period. The company's policy is to improve energy efficiency when replacing assets. However, the company has allowed for deterioration in the existing asset base which will offset this improved energy efficiency. • Scope 3 – An average value for the last three years was used. This is independent of distribution input. To reach the total carbon emissions the company has added the emissions from scope 1, 2 and 3. This gives emissions that start at 30,833 tonnes in 2015-16 and rise to 30,917 tonnes in 2019-20. Given the natural variability associated with these emissions, the company will use a constant 30,850 tonnes carbon dioxide equivalent per year throughout AMP6. The annual operational emissions per million litres of water was calculated by dividing the annual total carbon emissions by the distribution input for that year. This value is approximately 525 tonnes of carbon dioxide equivalent per million litres of water. The company will use this target as a key performance indicator.

Performance commitment E5: Number of severe pollution incidents

Detailed definition of performance measure: The number of severe pollution incidents, category 3 or worse, as reported by the Environment Agency.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of severe pollution incidents	Nr	0.3	0	0	0	0	0

Additional details

Necessary detail on measurement units	None
Frequency of PC measurement and any use of averaging	Annual
Any other information or clarifications relevant to correct application of incentive	It should be noted that the level of zero is a target not a performance commitment. It would be inappropriate to aim to fail.

Performance commitment E6: Environmental investigations

Detailed definition of performance measure: The number of environmental investigations or catchment management schemes to be carried out as part of the National Environmental Programme (NEP) as defined by the Environment Agency.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of environmental investigations or catchment	Nr	0	0	0	0	0	15

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
management schemes							

Additional details

Necessary detail on measurement units	None.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	The company is required to carry out 12 investigations and/or catchment management schemes as part of the NEP for water quality, and 3 investigations as part of the NEP for water resources.

Household retail outcome B: Offering good value for money, and keeping bills at a fair and reasonable level

Performance commitment B1: Number of customers that are in water poverty and receiving assistance

Detailed definition of performance measure: The criteria for eligibility are that the customer (or their partner) must be in receipt of one or more specified means tested benefits listed below.

- Income-based Jobseekers Allowance (JSA);
- Income Support;
- Income-related Employment and Support Allowance (ESA);
- Pension Credit (Guaranteed Credit only or a combination of Guaranteed Credit and Savings Credit); or
- Have a household income of less than the HMRC's low income threshold (currently £16,010) and be over 62 years of age or have a disability or have parental responsibility for a young child (under 5).

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of customers in water poverty and receiving assistance	Nr	2000	5000	5000	5000	5000	5000

Additional details

Necessary detail on measurement units	No further information required.
Frequency of PC measurement and any use of averaging	Annual.

Any other information or clarifications relevant to correct application of incentive	The number of customers receiving assistance is monitored through the company's 'Watersure' tariff.

Performance commitment B2: Effectiveness of bad debt recovery

Detailed definition of performance measure: Bad debt expressed as a percentage of turnover.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Bad debt as a % of total turnover	%	0.83	<1.00	<1.00	<1.00	<1.00	<1.00

Additional details

Necessary detail on measurement units	Debt is measured as the sum of the amount written off and the movement in the provision for doubtful debt as reported in the Annual Report.
Frequency of PC measurement and any use of averaging	Annual
Any other information or clarifications relevant to correct application of incentive	Easy for customers to understand as the concept of bad debt is used in other sectors. It is influenced by economic conditions and also by the way in which the company manages bad debt.

Performance commitment B3: Customer perception of value for money

Detailed definition of performance measure: The percentage of customers that say the company provides ‘good’ or ‘very good’ value for money in the company’s annual tracker survey.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
% who consider bills unaffordable	%	17	<15	<15	<15	<15	<15

Additional details

Necessary detail on measurement units	As part of the company’s tracker survey, customers are asked their views of the value for money the bill they receive represents.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	Information captured as part of the company’s tracker survey.

Household retail outcome D: Delivering consistently high levels of service

Performance commitment D1: Customer satisfaction

Detailed definition of performance measure: The level of satisfaction expressed by customers in response to the tracker survey (overall quality score)

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Overall level of satisfaction expressed	%	88	89	89.5	90	90	91

Additional details

Necessary detail on measurement units	The percentage of customers that are fairly or very satisfied with the overall quality of water services provided by the company determined from the company's tracker surveys.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	None.

Performance commitment D2: Service incentive mechanism

Detailed definition of performance measure: The service incentive mechanism industry customer service score achieved by the company.

Incentive type: Financial – Reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
SIM score	%	85	85.6	86.2	86.8	87.4	88

Additional details

Necessary detail on measurement units	SIM score as defined and measured by Ofwat.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	The SIM scoring mechanism may change from 2015 onwards. The target for 2020 is based on current methodology.

Performance commitment D3: Total number of complaints

Detailed definition of performance measure: The total number of complaints received per thousand billed properties. This includes all types of complaints such as written (letter and email), telephone complaints, in person and via other channels such as social media.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Number of complaints per 1,000 properties	Nr/ 1,000 prop	7.6	7.4	7.2	7	6.8	6.6

Additional details

Necessary detail on measurement units	Definition of a complaint to be based on that defined for written complaints and unwanted contacts in the June Return reporting requirements and definitions manual 2011, Section 2, Chapter 5.
Frequency of PC measurement and any use of averaging	Annual.
Any other information or clarifications relevant to correct application of incentive	The measure follows UKWIR criteria when considered together with the SIM and the overall satisfaction.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water sector in England and Wales provides customers with a good quality and efficient service at a fair price.

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