

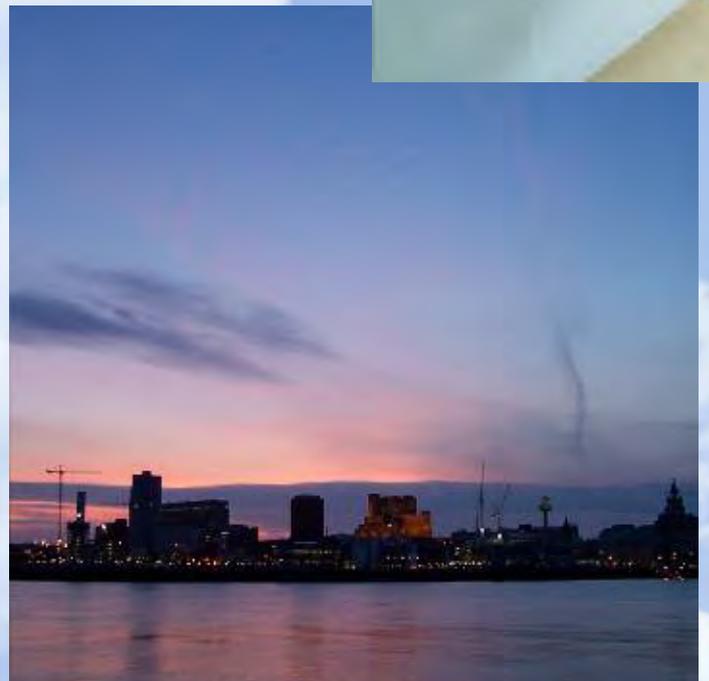
Setting price controls for 2015-20 Overview



Setting price controls for 2015-20 – overview

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Summary

The results of our price review mean customers in England and Wales will get more from their water companies while paying less for services over the next five years.

Companies' plans for delivering water and wastewater services are driven by what their customers, the environment and society want, now and in the future. This means that companies have promised to deliver more for their customers.

More

£44 billion investment
in improving services, improving resilience and protecting the environment. This equals an average of £2,000 of investment for every household over the next five years



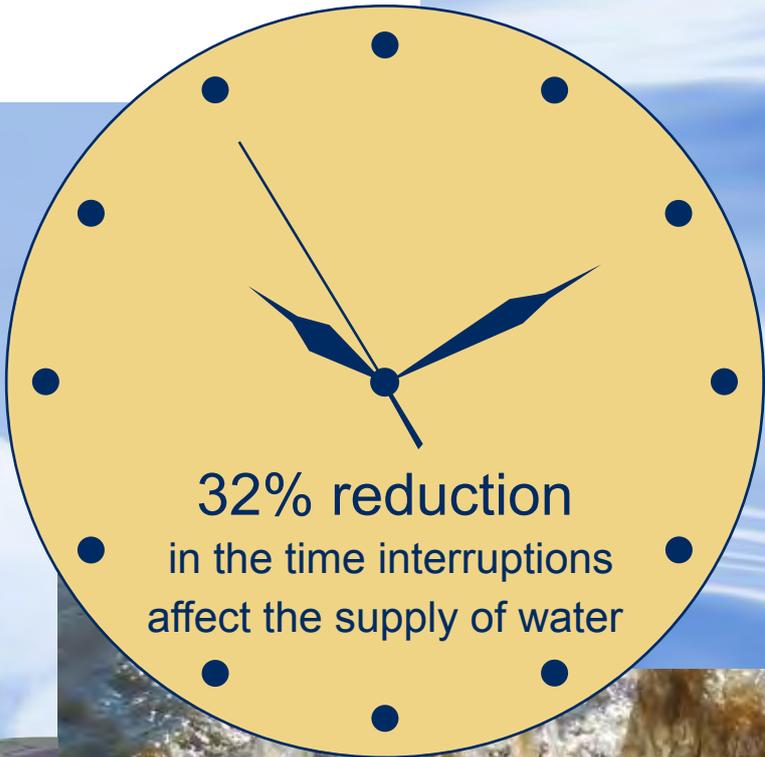
522 tailored performance commitments

developed with customers to deliver a high-quality service – with rewards and penalties on the companies to incentivise success

50 beaches
with improved water quality for bathing



1 million more people
receiving assistance through
schemes to help them with paying
their bill



32% reduction
in the time interruptions
affect the supply of water

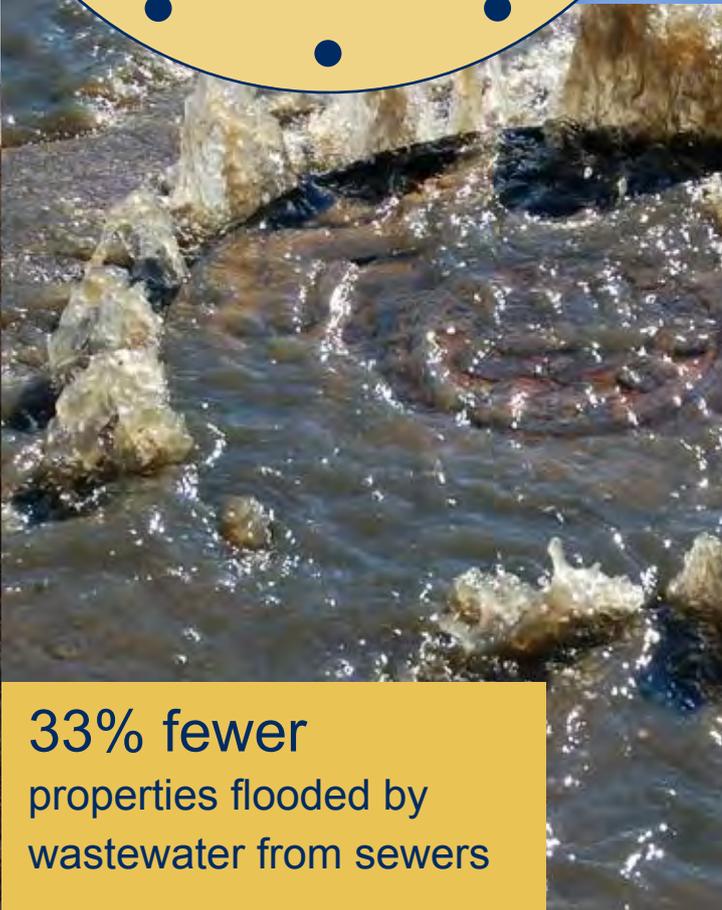
370 million litres of water
saved each day by tackling
leakage and promoting efficiency



For less

5% average drop
in water bills over the next
five years

33% fewer
properties flooded by
wastewater from sewers



Ofwat's price review

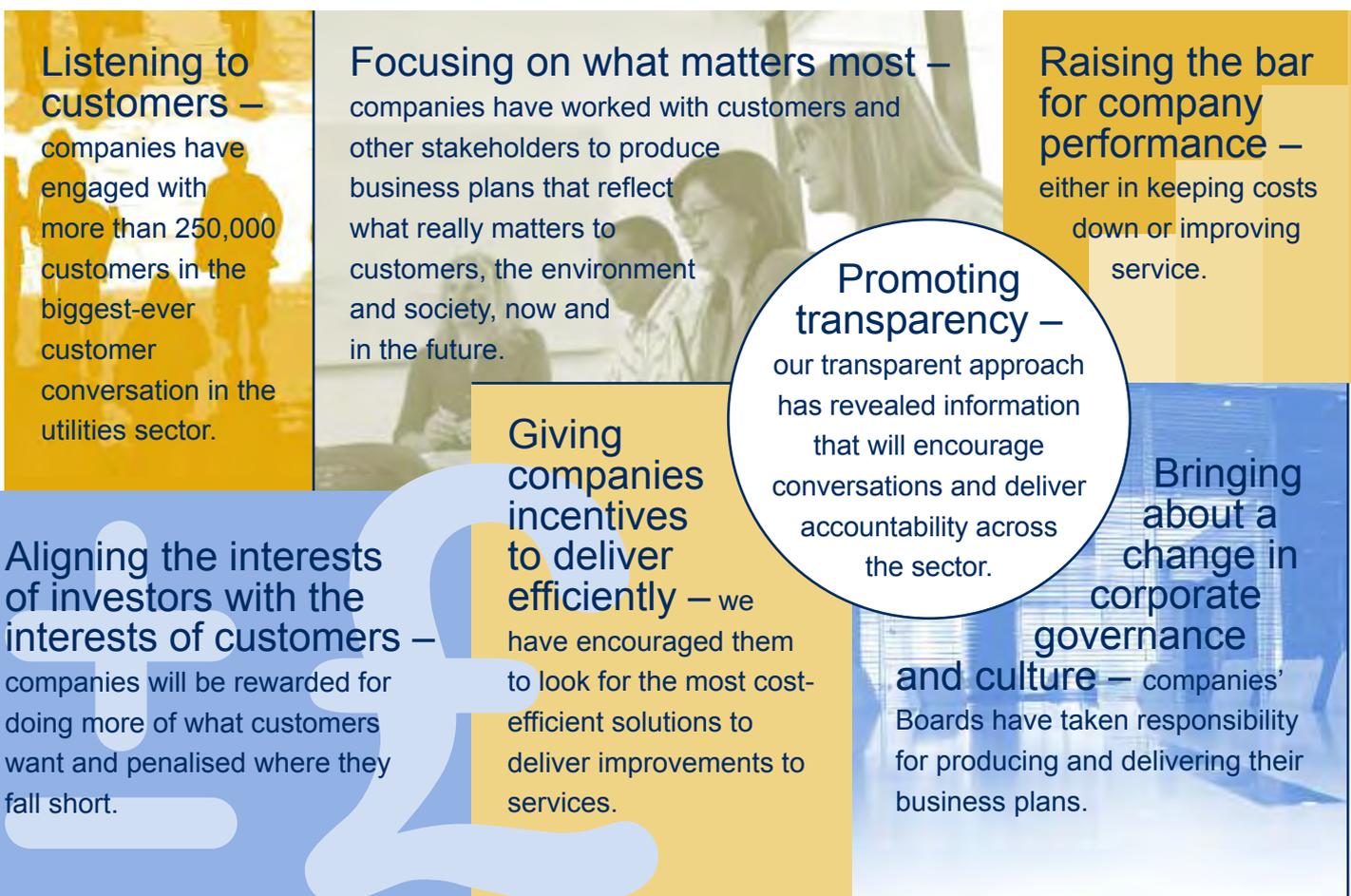
We have a role in protecting the interests of water and wastewater customers. As part of this, every five years we set limits on the prices companies can charge their customers.

For this price review (also known as 'PR14'), we set a framework that focused on companies delivering the services that matter to their customers and the environment. We challenged companies' business plans to make sure that there were incentives and penalties in place to drive the delivery of these services at the most efficient cost.

We also have a role in ensuring that efficient companies are able to finance their functions. This includes making sure that investors can earn a reasonable return on their investment (what we call the 'cost of capital'). We have assessed the balance of risk and reward – including the cost of capital and other key financial parameters – taking into account the latest market evidence.

We have made some significant changes to the way we regulate with this price review, and these principles will be at the heart of how we work going forward.

This price review has signalled a significant change of culture among water and wastewater companies. It has meant:



We adopted a risk-based approach to assessing companies' business plans and any interventions that followed. We focused our attention on the issues that could have the biggest impact on customers.

Overall, we saw a significant change within the sector, with companies responding to our challenge. Where companies have stepped up, we were able to allow more of their plans through.

For example, we decided that South West Water and Affinity Water were 'enhanced' companies because their plans required very few changes. These two companies have benefited from a 'do no harm' policy, which means they were insulated from some changes that would have made them worse off – for example, a lower cost of capital, which applied to non-enhanced companies, did not affect them. They also received direct financial and reputational benefits. This approach provides longer-term incentives for companies to improve the standard of the plans they deliver and shifts the frontier for what the sector can deliver for customers.

All other companies' business plans needed to improve or to be supported with further evidence. Some companies were able to deal with our feedback on their plans quickly, some had more work to do and were eventually able to close the gap, and others have found our feedback more challenging. Where necessary, we intervened to make sure customers get the best deal.

Biggest-ever challenge for sector on efficiency

We looked at the costs each company put forward and assessed them against what we considered the efficient costs were for delivering that service.

Overall, the companies put forward £45.7 billion of expenditure they said was necessary. We challenged where companies' costs were not efficient and well justified, and allowed only £44.3 billion.

Two business plans stood out

Highlights of Affinity Water's business plan

- An innovative company plan and vision – for example, reporting performance at a community level, as well as at a company level.
- Using the results of engagement with customers to help shape solutions to major challenges – in particular, a supply/demand deficit.
- Convincing evidence that its wholesale plan is efficient. Proposing to deliver efficiencies in retail costs to offset any increases in prices that are outside of the company's control.
- Convincing evidence that the Board provided strategic direction and leadership, and had assured itself that the company's business plan was a high-quality one.



Highlights of South West Water's business plan

- Two-year engagement programme: understanding customers' priorities and providing investment and bill options for customers to choose from.
- Responding to customer acceptability of proposed bill increases by scaling back investment in some areas and challenging itself further on efficiency.
- A comprehensive range of schemes to support customers who would find bills difficult to afford, including a social tariff put in place in 2013-14.
- A pledge to share the benefits of success fairly between customers and investors through 'WaterShare'.



More for customers: Delivering the outcomes customers want

Companies engaged in the biggest-ever customer conversation about the outcomes they want now and in the future in terms of the:

- service they receive; and
- benefits that will be delivered for the environment and wider society.

In total, companies engaged directly with more than 250,000 customers. They then developed a set of outcomes that their customers said they want and are willing to pay for. They developed 522 individual performance commitments to deliver those outcomes.

These outcomes will provide a range of benefits for customers, including:

- better customer service;
- more efficient use of water;
- long-term resilience of water supplies; and
- a cleaner environment, both now and in the future.

We have tested the costs that companies say they will need to incur to deliver these outcomes. If we thought that a company could deliver the outcomes at a more efficient cost, we have reduced the allowed expenditure.

We made sure that companies consulted customers about how performance against their commitment levels should be rewarded or penalised. In some areas, customers are willing to pay more if their company delivers more than its stated commitments (in other words, companies can earn a reward for 'outperformance'). If companies fall short of their commitments, they will be penalised financially. Companies' performance will be very transparent, so we would also expect reputational benefits or harm to companies depending on their performance.

What is an outcome?

Affinity Water



“Making sure our customers have enough water, while leaving more water in the environment”



Example performance commitment:
Reduced average water use

In response to customer feedback, Affinity Water has committed to reducing demand between 2015 and 2020 through metering and a water efficiency programme. It has also committed to using water more efficiently, including a 14% cut in leakage by 2020.

Anglian Water



“A flourishing environment”



Example performance commitment:
Beaches with 'excellent' water quality

Anglian Water has committed to increasing the percentage of its beaches with 'excellent' water quality as defined under the EU's revised Bathing Water Directive from 58% to 67%.

Flexibility to spend money where it is most needed

Severn Trent Water

“We will ensure water is always there when you need it”

Example performance commitment:
Delivering the outcome of the Birmingham resilience scheme

Severn Trent Water has committed to delivering a major scheme to improve Birmingham resilience – the Elan Valley Aqueduct. The success of the scheme in terms of delivering resilience to customers will be assessed by measuring the capacity delivered by the project. A penalty will be applied in proportion to any shortfall in capacity delivered.



South West Water

“Protecting the environment”

Example performance commitment:
The number of acres of farmland under revised management to deliver environmental outcomes and the number of farms where a plan has been agreed to benefit the environment



South West Water's 'Upstream thinking programme' will see an increase in farming methods that take into account the needs of local water catchments ('catchment management') – more than doubling the number of farms involved (from 650 to 1,400).

In previous price reviews, we split companies' expenditure allowance into two pots:

- capital expenditure (long-term investment); and
- operational expenditure (day-to-day running costs).

We asked them to provide a breakdown of all their costs, including for specific projects (such as building a new water treatment works), and we measured their performance against delivery of those projects. This approach rewarded capital expenditure to a greater extent than operational expenditure, which helped bring much-needed investment into the sector, but did not always encourage companies to find the most efficient solution overall.

For this price review, we have allowed companies a single pot of total expenditure (what we call 'totex').

This means they can choose the best solutions to deliver the outcomes they have committed to.

Focusing on outcomes over the next five years rather than on specific schemes means companies can choose to spend the money we allow them to recover from customers on:

- investing in new infrastructure;
- maintaining existing infrastructure; or
- adopting other solutions.

This gives them opportunities and incentives to develop innovative solutions, which will lead to long-term efficiency gains for customers.

We have also separated the costs associated with different parts of the companies' business into:

- wholesale costs (for wastewater and for water), which are the costs associated with maintaining and developing the network and other assets that deliver water and wastewater services to customers; and
- retail costs (for domestic household customers and business customers), which are the costs associated with customer services such as billing, payment handling, debt management and meter reading.

Overall, these changes to the way in which companies look at costs incentivise efficiency and innovation, and allow a light to be shone on the real cost of the services customers are paying for.

More for customers: Delivering the outcomes customers want

It is now time for companies to implement their plans for the next five years in a way that delivers real benefits for customers

Sector-wide service improvements that companies are incentivised to deliver for their customers between 2015 and 2020

100% compliance with the target level of quality for drinking water

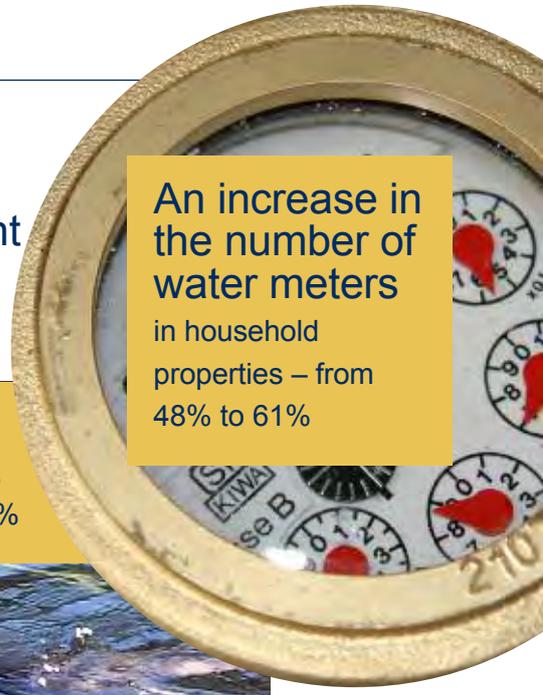
34% reduction in customers contacting their local company about problems with the colour, taste or smell of water

33% reduction in the number of properties flooded by wastewater from sewers

32% reduction in the time lost to supply interruptions

370 million litres of water a day saved by tackling leakage and promoting water efficiency – enough to serve all of the homes in Birmingham, Liverpool and Leeds

Sector-wide service improvements that companies are incentivised to deliver to protect the environment and meet their statutory environmental obligations



An increase in the number of water meters in household properties – from 48% to 61%



Reducing pollution events – a zero target for serious pollution incidents, with other incidents dropping by 22%



Developing more than 100 catchment management schemes, including working with farmers and landowners to help improve drainage and control pollution

Strong and effective relationships

The relationship between companies and their customers is essential, but other relationships also matter, including those that affect the environment, the economy and wider society.

As part of this price review, companies set up independent customer challenge groups (CCGs), which included:

- customers and their representatives;
- local authorities;
- businesses; and
- environmental groups.

CCGs played an important role in helping to scrutinise companies' business plans. They:

- challenged the quality of the customer engagement process;
- challenged how well the company's proposed outcomes and outcome delivery incentives reflected its customer engagement and customers' priorities; and
- provided independent reports during the price review process.



Meeting environmental compliance targets – including cleaner water at more than 50 beaches

We have also engaged extensively with stakeholders during this price review so that we can be sure our decisions deliver the best result for customers. In making our final decisions (or 'determinations'), we have taken into account the views we received from all stakeholders.

More for customers and companies: Balancing risk and reward

Through the incentives we are putting in place in this review we are aligning the interests of company management and investors with the interests of customers.

The returns that companies can offer their investors are based on a package of effective rewards and penalties. This benefits customers by:

- providing meaningful incentives to deliver the best service;
- placing responsibility on companies to manage any risks over which they have some control; and
- sharing the savings if their local water company delivers its plan below cost estimates.

We have balanced the level of risk and reward – including the cost of capital and other key financial parameters – taking account of evidence about current financial market conditions.

At a high level, the package of effective rewards and penalties is made up of:

Base return

A 'base' return of 3.74%, which we set by looking at what investors in other low-risk, regulated businesses require when they invest their money. Part of this will be earned by a 3.6% base return on the wholesale assets, and part through a 1% margin on retail bills. Our efficiency challenge means companies will need to work harder than ever before to achieve a base level of return.

Risk of underperformance

Companies may earn less than the base return if, for example:

- they spend more than we allow to deliver their investment programme;
- they fail to deliver the commitments they have made to customers; and
- the cost of debt rises faster than we expect.

Companies will have to compensate customers if they fail to deliver their performance commitments.

Opportunity for outperformance

Conversely, companies may do better if they:

- deliver their investment programme for less;
- outperform their performance commitments; and
- find lower-cost sources of finance than we assumed.

In all of these cases, customers will benefit over time.

Competition for business customers

For the next two years, companies will retain their existing business customers and earn a 2.5% margin. But in 2017 this part of the business will be opened to competition, and companies may do better or worse depending on their success in controlling costs and winning customers.

Setting the cost of capital

For the five years covered by this price review (2015 to 2020), we have set the cost of capital for the whole business at 3.74%. This is a reduction from the 5.1% we set at the last price review for the five years between 2010 and 2015.

Below, we set out the impact of the interventions in the level of the cost of capital that we have made during this price review

December 2013 Business plans

When companies submitted their business plans in December 2013 they said that the cost of capital was between 4.1% and 4.9%. We did not consider that any of them had proposed a figure that aligned with market evidence.

January 2014 Risk and reward guidance

In January 2014, we published guidance for companies on risk and reward, which included our view on the cost of capital of 3.85%. With the exception of Dee Valley Water, all companies accepted our view.

August 2014 Draft determinations

We made our draft decisions (or 'determinations') in August based on the same cost of capital of 3.85%. We said we would consider the latest market evidence in making our final determinations.

December 2014 Final determinations

The cost of capital of 3.74%, based on a forward-looking view of the costs of finance over the five-year period 2015 to 2020, allows customers to benefit from recent falls in the cost of finance through lower bills, while offering the shareholders of efficient companies a reasonable return on their investment.

The two enhanced companies will have the cost of capital of 3.85% that was included in their draft determinations. This is because our 'do no harm' principle protects them from the subsequent fall in the cost of capital that applies to the other companies.

The cost of capital and small companies

We have allowed Portsmouth Water and Sembcorp Bournemouth Water a cost of capital premium of 0.15%. They showed both that their relatively small size means they are not able to obtain finance on the same terms as larger companies, and that they provide customer benefits because they are efficient companies which act as a benchmark for others in the sector.

Our challenge
on the cost of capital
has resulted in more
than £2 billion of
savings for
customers

Customers paying less

Making sure that companies provide a safe and reliable service and deliver outcomes customers want is crucial. Equally important is making sure that those services are at a cost that customers are willing and able to pay.

Most companies listened to their customers' concerns about value for money and affordability. And they considered their customers' views when producing their business plans.

£376

Average combined
water and wastewater
bill by 2019-20

Customers will
pay **£3 billion less**
than proposed in company
business plans as a result
of our challenge

£1.5 billion less
in 2015-20

-4%

The amount bills
will be lower by
2019-20 than they
would have been
under companies'
original plans

Water and wastewater bills will be 5% lower on average in 2019-20 compared with 2014-15

We also asked companies to consider how they could improve support to those who might struggle to pay their bill. As a result:

- over the next five years, companies are putting in place measures, such as social tariffs, which are forecast to help an additional one million people. This will more than double the number of people benefiting from financial support to around 1.8 million by 2020; and
- currently around 60,000 people benefit from social tariffs, which set a cap on bills for those struggling to pay. This is set to rise to more than 850,000 people benefiting by 2020.

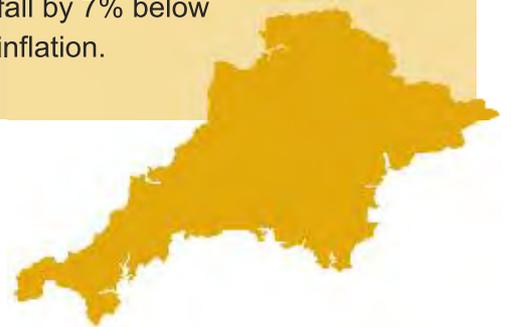
Companies will need to decide the level at which they will set charges for customers each year. Price controls are not the same as bills to customers: price controls set overall limits on the money companies can collect from their customers, what they must deliver to their customers in return and any rewards or penalties depending on whether they exceed or fall short of expectations. Companies have some flexibility to set yearly charges within these restrictions. The first charges set will come into force in April 2015.



£1.5 billion
less after 2020

Listening to customers

When South West Water talked to its customers, it found they liked its plans, but were concerned about the cost. As a result, the company found ways to lower the costs of its plans, resulting in a £31 reduction in proposed bills, while still delivering the things that customers wanted. Its plans subsequently received 84% customer approval and bills will fall by 7% below inflation.



Customers paying less

Changes to the average annual combined bill for water and sewerage companies (£)

Ofwat's final determination				Companies' 2013 December requests
	2014-15	2019-20	Five-year change	Requested five-year change
National average bill	£396	£376	-5%	-2%
Anglian	431	390	-10%	-8%
Dŵr Cymru	440	416	-5%	-4%
Northumbrian	388	382	-1%	0%
Severn Trent	333	316	-5%	-4%
Southern	437	403	-8%	-2%
South West	545	506	-7%	-4%
Thames	370	353	-5%	3%
United Utilities	410	398	-3%	0%
Wessex	485	442	-9%	-4%
Yorkshire	373	361	-3%	-1%

Inflation

Inflation is a rise in the price of goods and services we buy. The figures are compiled by the Office for National Statistics.

Inflation affects the costs companies face in providing water and wastewater services. We allow them to adjust the wholesale element of their costs (about 90% of their total costs) by the rate of inflation, before then challenging them to achieve efficiencies. The retail price controls are not automatically adjusted for inflation as we do not consider it appropriate for the less asset- and capital-intensive retail businesses.

This means that inflation will affect the amount customers pay. The bill numbers presented here do not include the effect of inflation because we do not yet know what inflation will be in each of the next five years.



Changes to the average annual water bill for water only companies (£)

Ofwat's final determination				Companies' 2013 December requests
	2014-15	2019-20	Five-year change	Requested five-year change
Affinity	176	163	-7%	-4%
Bristol	202	160	-21%	1%
Dee Valley	152	149	-2%	8%
Portsmouth	97	96	-1%	-1%
Sembcorp Bournemouth	153	134	-12%	-6%
South East	201	194	-3%	3%
South Staffordshire	141	135	-4%	2%
Sutton & East Surrey	186	180	-3%	-5%

1. Please note all bills are in 2014-15 prices. In addition to a positive or negative allowance from Ofwat, companies can raise the wholesale element of their bills in line with inflation (RPI) on a year-by-year basis. Note that bills numbers in the company-specific appendices published alongside this document are in 2012-13 prices.

2. The average combined customer bill for South West does not reflect the £50 per customer Government contribution towards household bills. This addresses the significant investment needed in the infrastructure which was inherited by the company at privatisation to meet environmental and drinking water quality standards.

3. Thames Water's figures include the costs for the preparatory works to build the Thames Tideway Tunnel – a 25 km sewer to deal with the problem of too much sewage overflowing into the River Thames. However, it does not include costs for the construction of the tunnel. This is because the project will be financed and delivered by an independent infrastructure provider (IP). The IP is expected to be appointed in 2015.

4. Individual household customers' water bills may vary depending on their water and wastewater usage. Some household customers receive bills from separate water and wastewater providers.

5. Companies are responsible for setting bills. It is for companies to decide each year the level at which they will set charges for customers consistent with Ofwat's final determinations.

More for less across England and Wales

Price changes and selected performance commitments over the next five years

Northumbrian

£
-1%

- Maintaining pipes, pumping stations and treatment works ('infrastructure') to deliver the water service customers expect. This includes managing issues such as low pressure and mains bursts.
- Maintaining infrastructure to deliver the wastewater service customers expect. This includes managing sewer collapses, pollution incidents and sewer flooding.
- Reducing the time lost to supply interruptions by about 30%.

Yorkshire

£
-3%

- Maintaining sewerage network to provide stable, reliable services in line with customer expectations.
- Reducing the time lost to supply interruptions by more than 15%.
- Target of no serious pollution incidents by 2020, and a reduction of around 16% in other pollution incidents.

United Utilities

£
-3%

- A 49% reduction in the number of properties affected each year by internal sewer flooding.
- Reducing the time lost to supply interruption by more than 30%.
- Maintaining pipes, pumping stations and treatment works ('infrastructure') to deliver the water service customers expect. This includes managing issues such as low pressure and mains bursts.

Severn Trent Water

£
-5%

- A 21% reduction in the number of properties affected each year by internal sewer flooding.
- Reducing the time lost to supply interruptions by almost 50%.
- Providing an alternative source of water supply to Birmingham, to improve the resilience of supplies for around a quarter of million people.

Anglian

£
-10%

- Reducing the time lost to supply interruptions by almost 40%.
- A 27% reduction in pollution incidents.
- Increasing the proportion of beaches achieving 'excellent' status from 58% to 67%.

Dŵr Cymru

£
-5%

- An 8% reduction in leakage levels.
- A 14% reduction in the number of properties affected by internal sewer flooding.
- Reducing the number of category 3 pollution incidents by more than 40%.

Wessex

£
-9%

- Significant improvements in river water quality through investment at sewage treatment works.
- A 6% reduction in the number of yearly incidents of sewer flooding.
- A target of no hosepipe bans.

Thames

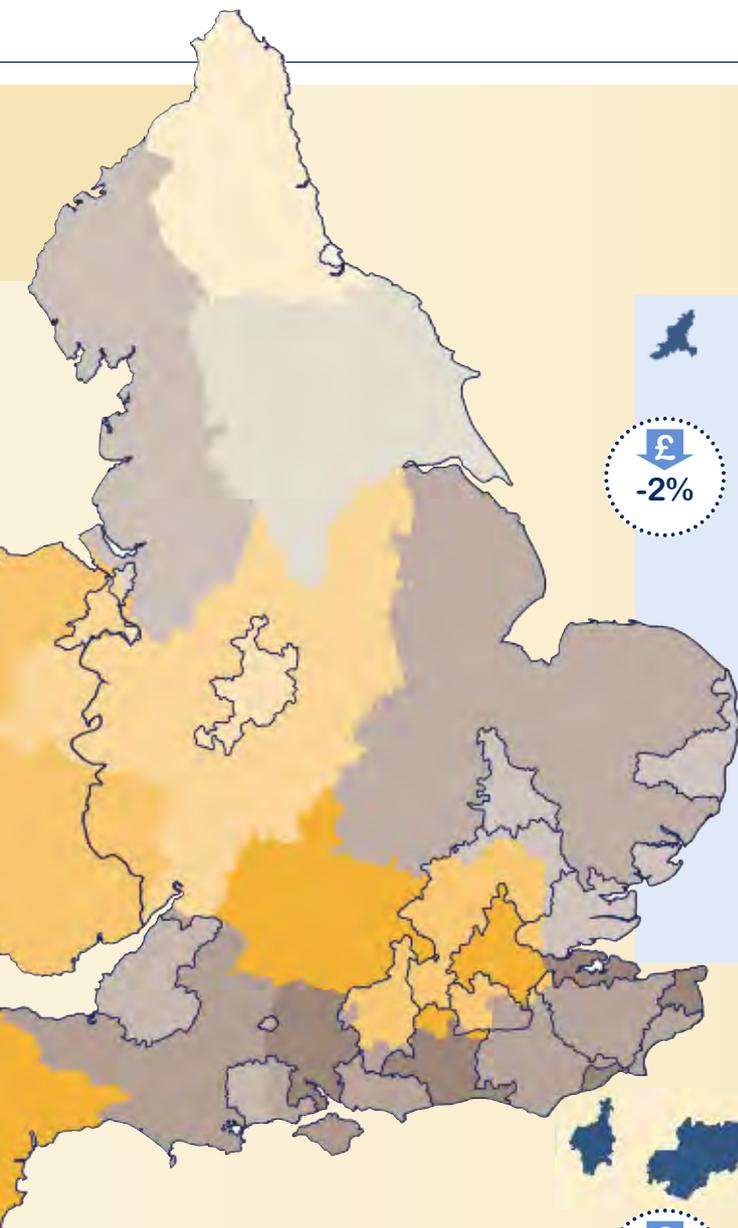
£
-5%

- A 10% reduction in the number of yearly instances of properties being affected by internal sewer flooding.
- A 9% reduction in leakage levels.
- Preparatory works for building the Thames Tideway Tunnel, a project to deal with the problem of too much sewage going into the River Thames.

South West

£
-7%

- Improving the quality of bathing water at 15 sites, so that all beaches meet or exceed environmental standards by 2020.
- A 14% reduction in annual incidents of properties being affected by internal sewer flooding.
- Reducing the number of hours lost to supply interruptions by 25%.



Dee Valley

- Upgrading a water treatment works to provide the level of service customers' expect. This includes ensuring appropriate drinking water quality and appearance.
- Reducing the amount of time lost to supply interruptions by around 40%.



Affinity

- A 14% reduction in leakage levels.
- Protecting the environment by reducing the volume of water taken from rivers by around 42 million litres a day.



South Staffordshire

- Reducing the number of contacts about the acceptability of water by more than 30%.
- Maintain top 25% performance in managing the amount of time lost to supply interruptions.



South East

- A 5% reduction in leakage levels by 2020.
- Reducing the average amount of time lost to supply interruptions by about 8%.

Sutton & East Surrey

- Reducing the amount of time lost to supply interruptions by about 30%.
- Reducing leakage levels by 2%.



Bristol

- A 10% reduction in leakage levels by 2020.
- Improving the resilience of supplies to reduce the number of people at risk of losing their water supplies by 97% – from around 290,000 people to 9,000 people.



Sutton & East Surrey

- Reducing the amount of time lost to supply interruptions by about 30%.
- Reducing leakage levels by 2%.



Portsmouth

- A 1% reduction in leakage levels.
- A 5% reduction in the number of contacts about drinking water quality, including issues such as colour, odour and taste.



Southern

- A 30% reduction in the yearly incidents of properties being affected by internal sewer flooding.
- Improving bathing water quality, with a target of seven more beaches gaining 'excellent' status.
- Target of no customers affected by temporary use bans before two consecutive dry winters.



Semcorp Bournemouth

- Maintaining pipes, pumping stations and treatment works ('infrastructure') to deliver the level of service customers expect.
- Reducing levels of leakage by 7%.

The percentage figure shows how much the average bill will change before inflation between 2015 and 2020. Please see pages 14 and 15 for more details.

A foundation for the future

Our price review is a foundation for Ofwat's future strategy and vision.

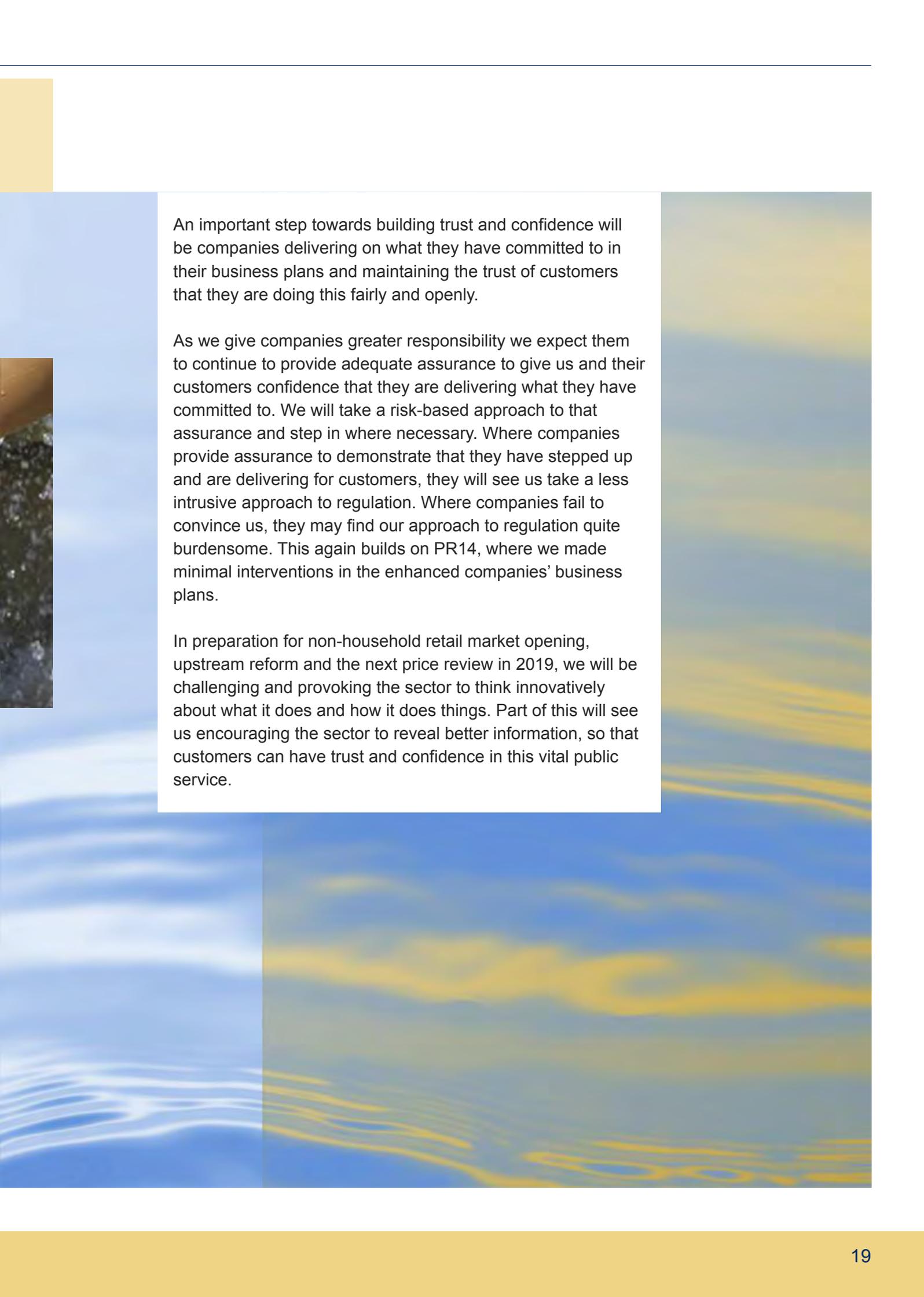
We have a vision that the sector is one in which customers have trust and confidence. We think that everyone should have trust and confidence in the vital public services provided by this sector. That is:

- Trust and confidence in the quality of our drinking water.
- Trust and confidence in the resilience of services – that they will be value for money and affordable.
- Trust and confidence in customer service and in fair dealing.
- Trust and confidence in the stewardship of the environment.
- More generally, trust and confidence that decisions taken today will not impoverish future generations.



To achieve this vision, the sector needs to build on what it has achieved in this price review. Companies must continue to strengthen relationships with their customers and their stakeholders, recognising the importance of the whole sector for the environment, the economy and wider society.

We are giving companies greater responsibility for owning these relationships, so that they can understand what priorities their customers and society expect. It is important that companies recognise that these priorities might change over time and are able to respond to these changes to deliver the outcomes their customers want. We have seen some great examples of this in this price review. Companies have proposed 522 performance commitments that will see them rewarded for doing more of what customers want and penalised where they fall short.



An important step towards building trust and confidence will be companies delivering on what they have committed to in their business plans and maintaining the trust of customers that they are doing this fairly and openly.

As we give companies greater responsibility we expect them to continue to provide adequate assurance to give us and their customers confidence that they are delivering what they have committed to. We will take a risk-based approach to that assurance and step in where necessary. Where companies provide assurance to demonstrate that they have stepped up and are delivering for customers, they will see us take a less intrusive approach to regulation. Where companies fail to convince us, they may find our approach to regulation quite burdensome. This again builds on PR14, where we made minimal interventions in the enhanced companies' business plans.

In preparation for non-household retail market opening, upstream reform and the next price review in 2019, we will be challenging and provoking the sector to think innovatively about what it does and how it does things. Part of this will see us encouraging the sector to reveal better information, so that customers can have trust and confidence in this vital public service.

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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