

May 2014

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



OFWAT

Overview

Overview of draft determinations for Northumbrian Water and Dŵr Cymru

This document sets out our draft determinations of price controls for Northumbrian Water and Dŵr Cymru, for the five years from 1 April 2015.

In ‘[Setting price controls for 2015-20 – pre-qualification decisions](#)’ we invited all 16 companies that had not qualified for enhanced status to request a draft determination of 2015-20 price controls by June rather than August 2014.

On 6 May we confirmed that two companies, Northumbrian Water and Dŵr Cymru (Welsh Water), would receive an early draft determination. We have made our draft determinations for both companies earlier than originally planned.

Both companies have submitted plans that deliver the outcomes that their customers want and can afford. This has occurred because of a combination of greater Board involvement, the challenge provided by the customer challenge groups (CCGs) and targeted regulatory incentives. For these reasons, and because the development of the plans has been led by companies' individual Boards, we are also seeing more divergence about what the companies will deliver for customers than in the past.

The risk-based review has been instrumental in improving the quality of business plans by shining a light on aspects of the December 2013 plans that required further development. Similarly, there are also important changes in the revised plans – most notably around the weighted average cost of capital – as the companies have sought to take into account our [risk and reward guidance](#).

While there have been a number of positive changes to the business plans, in a small number of instances we have had to intervene to protect customers. The targeted and proportionate interventions for Northumbrian Water and Dŵr Cymru are designed to ensure that companies are only rewarded for delivering for their customers. We expect that the two companies could address our concerns in some areas and as such the final position for their customers will not be known until the final determinations.

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

Summary of Northumbrian Water and Dŵr Cymru draft determinations

Both companies will reduce bills relative to inflation, deliver better services and meet their statutory obligations in the next control period.

Our draft determinations are based on the companies' revised business plans, submitted on 2 May 2014. However, unlike our treatment of the enhanced company business plans – which we accepted in the round – we have made a small number of interventions to protect the interests of customers. The **information summarised in this note reflects our determination on the basis of the company's plan after our interventions**, which are also summarised at the end of this note.

The following sections provide a summary of:

- the impact each draft determination will have on average household customer bills;
- the outcomes each company will deliver for its customers;
- the allowed revenues and returns for each company; and
- the areas where we have intervened.

The details of Northumbrian Water and Dŵr Cymru's draft determinations are set out in the relevant company-specific appendix.

Average household customer bills

Table 1 sets out the impact of our draft determinations for Northumbrian Water and Dŵr Cymru on average household customer bills over the period 2015-20. By 2019-20, **overall bills for directly-provided regulated services will fall by around 2% and 5% in real terms for Northumbrian Water and Dŵr Cymru respectively**, relative to average bills in 2014-15. We have not separately calculated the average bills for the two regions served by Northumbrian Water (North East of England and in Essex and Suffolk). This is because we do not set separate controls for the different regions.

The profile of bills for each company reflects the profiles proposed in their revised business plans.

In the 2014 price review we have given companies more flexibility over whether they ‘expensed’ costs – recovering them in the current control period – or whether they added them to the regulatory capital value (RCV) to be depreciated over a number of control periods. Northumbrian Water and Dŵr Cymru have used these financeability levers in different ways, although, the overall impact has been to increase costs recovered in the 2015-20 period and reduce RCV growth compared to their December plans. This has the effect of sharing the benefits of the lower cost of capital between 2015-20 and beyond this period, balancing improving affordability of plans with maintaining financeability.

While we have introduced these tools to specifically address financeability issues (as both companies have done), our expectation is that all companies continue to engage with customers on the use of these levers and in particular on the implications of their use for current and future bills.

Table 1 Summary of average household customer bills

| | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Change (£) |
|------------------------------------|---------|---------|---------|---------|---------|---------|------------|
| Customer bill – Northumbrian Water | 368 | 362 | 362 | 362 | 362 | 362 | 6 |
| Customer bill – Dŵr Cymru | 416 | 409 | 407 | 403 | 398 | 396 | 21 |

Notes:

Customer bills for our draft determination are based on an implied menu choice.

We use average household bills to provide a broad indication of the movement that customers will see, but the actual bill will depend on an individual customer’s specific circumstances.

Average bill for water and sewerage customers are shown in real terms. An adjustment for inflation (relating to the wholesale control) will also be reflected in the bills customers will pay.

As with the enhanced draft determinations, the average customer bill illustrated above reflects a notional allocation (by Ofwat but based on the company’s split of household and non-household) of the overall revenue requirement across Northumbrian Water’s customer base. In practice, companies will have some flexibility about how they recover the revenue requirement from different types of charge. Company charges must be in accordance with our charging rules, which we will be consulting on shortly.

Outcomes for customers

The outcomes in the draft determinations reflect the respective priorities and commitments that Northumbrian Water and Dŵr Cymru developed in consultation with their own customers.

We summarise the outcomes for both companies in tables 2 and 3 below. Full details of each company’s performance commitments are set out in the company-specific appendices that accompany this document.

In this area particularly, we recognise that the work of the CCGs has ensured that the plans for both Northumbrian Water and Dŵr Cymru reflect customers’ priorities.

Table 2 Summary of Northumbrian Water’s outcomes

| Wholesale water | Wholesale wastewater | Retail |
|---|---|---|
| Deliver water and wastewater services that meet the needs of current and future generations in a changing world – including taking measures to monitor, protect and incentivise the long-term sustainable health of assets | Deliver water and wastewater services that meet the needs of current and future generations in a changing world – including taking measures to monitor, protect and incentivise the long-term sustainable health of assets | Retailer of choice for business customers – through a measure of business customer satisfaction |
| Supply clean, clear drinking water that tastes good – including maintaining the overall level of drinking water compliance | Provide a sewerage service that deals effectively with sewage and heavy rainfall – including ensuring that current levels of sewer flooding do not increase | Provide excellent service and impress our customers – including measuring performance against an independent overall customer satisfaction score |

| Wholesale water | Wholesale wastewater | Retail |
|--|--|--|
| <p>Provide a reliable and sufficient supply of water – including reducing the target level of leakage in the Northern (Northumbrian) operating region and maintaining it in the Southern (Essex and Suffolk) operating region</p> | <p>Help to improve the quality of rivers and coastal waters for the benefit of people, the environment and wildlife – including ensuring that the current number of pollution incidents do not increase</p> | <p>Our customers consider the services they receive to be value for money – including through an independent value for money survey</p> |
| <p>Provide excellent service and impress our customers – including measuring performance against an independent overall customer satisfaction score</p> | <p>Provide excellent service and impress our customers – including measuring performance against an independent overall customer satisfaction score</p> | <p>Customers are well informed about the services they receive and the value of water – through an independent survey on keeping customers informed</p> |
| <p>Customers are well informed about the services they receive and the value of water – through an independent survey on keeping customers informed</p> | <p>Customers are well informed about the services they receive and the value of water – through an independent survey on keeping customers informed</p> | <p>Protect and enhance the environment in delivering our services, leading by example – including reducing the current levels of greenhouse gas emissions</p> |
| <p>Protect and enhance the environment in delivering our services, leading by example – including reducing the current levels of greenhouse gas emissions</p> | <p>Protect and enhance the environment in delivering our services, leading by example – including reducing the current levels of greenhouse gas emissions</p> | |

Table 3 Summary of Dŵr Cymru’s outcomes

| Wholesale water | Wholesale wastewater | Retail |
|--|---|---|
| Safe clean drinking water – including maintaining compliance with drinking water standards | Protecting our environment – including reducing the number of pollution incidents | ‘Best in class’ customer service – including improving performance in non-household customer satisfaction surveys |
| Protecting our environment – covering ensuring compliance with permits for abstraction water for use | Responding to climate change – including reducing amount of surface water in wastewater network | Affordable prices – including for household customers increasing the number of disadvantaged customers benefiting from social tariffs and for non-household customers maintaining affordable bills |
| Responding to climate change – including increasing the amount of renewable energy generated | ‘Best in class’ customer service – including reducing the number of properties flooded by sewers | |
| ‘Best in class’ customer service – including reducing the number of customers who experience poor service | Affordable prices – by maintaining affordable bills | |
| Affordable prices – by maintaining affordable bills | Asset stewardship - including improving asset resilience | |
| Asset stewardship – including reducing the current levels of leakage | | |

For household retail, all companies, including Northumbrian Water and Dŵr Cymru, will be measured against the service incentive mechanism (SIM). The SIM contains both rewards and penalties to incentivise excellent customer performance.

The Welsh Government has decided not to extend retail competition to non-households customers of Dŵr Cymru that consume less than 50 Ml a year. Because of this the non-household price controls will include a service incentive for delivery of services to non-households served by companies wholly or mainly in Wales.

Allowed revenues and returns

The risk and reward package put forward by both companies reflects our risk and reward guidance. In particular, both Northumbrian Water and Dŵr Cymru have adopted a wholesale weighted average cost of capital of 3.7% and retail net margins of 1% and 2.5% for household and non-household respectively.

Despite using similar inputs, both companies have used the individual financeability levers in different ways. As noted above, both company have used levers to bring cash forward compared with their December plans. However, in their December plans, they adopted different approaches to balance between cash in period and RCV growth and these differences are still reflected in these plans. For example, consistent with its December plan, Northumbrian Water is taking more cash in the next period at the expense of RCV growth by using a faster RCV run off and so recovering RCV over a shorter period of time – this results in comparatively higher bills in 2015-20 and lower bills in the future, as the RCV is now forecast to cumulatively reduce by 0.3% between 2015-20. In contrast, Dŵr Cymru is growing the RCV by adopting a slower RCV run off of assets (2.6% compared to Northumbrian Water's use of 6.1%)¹, which results in comparatively lower bills in 2015-20 but relatively higher bills in future periods, as the RCV cumulatively grows by 6.8% between 2015 and 2020.

Both Northumbrian Water and Dŵr Cymru withdrew the adjustment to their retail average cost to serve (ACTS) for input price pressure over 2015-20. In addition, Northumbrian Water withdrew its proposed adjustment for bad debt due to deprivation. Dŵr Cymru, on the other hand, submitted revised evidence on the bad debt adjustment and, while we agreed, we have intervened in relation to the size of the adjustment.

Table 4 below sets out the core components of our draft determinations in respect of allowed costs and returns – for each of the four separate price controls for Northumbrian Water and Dŵr Cymru.

¹ Northumbrian Water adopted straight line depreciation and Dŵr Cymru adopted reducing balance depreciation.

Table 4 Summary costs and returns

| | Allowed costs/expenditure | Northumbrian Water | Dŵr Cymru |
|----------------------|---|--------------------|-----------|
| Household retail | Cost allowance – 2015-20 total (£m) | 252.3 | 234.7 |
| | Margin (%) | 1.0 | 1.0 |
| | Average bill per household customer – retail component only (£) | 33 | 40 |
| Non-household retail | Cost allowance – 2015-20 total (£m) | 36.6 | 25.6 |
| | Margin (%) | 2.5 | 2.5 |
| Wholesale water | Totex – 2015-20 total (£m) | 1,330.7 | 1,235.8 |
| | Allowed cost recovery in 2015-20 ¹ (£m) | 1,398.9 | 1,119.0 |
| | Allowed weighted average cost of capital (%) | 3.7 | 3.7 |
| | Allowed wholesale revenue in 2015-20 ² (£m) | 1,910.7 | 1,307.9 |
| Wholesale wastewater | Totex – 2015-20 total (£m) | 1,004.9 | 1,357.9 |
| | Allowed cost recovery in 2015-20 ¹ (£m) | 946.3 | 1,151.2 |
| | Allowed weighted average cost of capital (%) | 3.7 | 3.7 |
| | Allowed wholesale revenue in 2015-20 ² (£m) | 1,384.1 | 1,753.5 |

Notes:

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

Under the price controls within these draft determinations, investors will earn fair returns for the risks they are taking provided the companies deliver the plans and commitments. The companies will be able to share additional rewards with their customers if they outperform the targets set out in their plans. We consider that the potential for companies to earn additional financial rewards provides a strong incentive for them to deliver additional value for their customers and to outperform their allowed costs.

As explained in '[Setting price controls for 2015-20 – policy and information update](#)', we propose a 'standard menu' for cost outperformance incentives for Northumbrian Water and Dŵr Cymru. This differs from the menu for South West Water and Affinity Water, which was specifically designed for those companies awarded enhanced status. Further detail is set out in Annex 2 of each of the company specific appendices.

The areas where we have intervened

We identified some areas where we have considered it necessary to intervene to protect the interests of consumers. This may be for a number of reasons, for example if:

- we consider that the company has not provided sufficient evidence to support a proposal;
- proposals are not sufficiently challenging; or
- proposals are not in customers' interests.

We explain the details of and reasons for each intervention in the appropriate sections of the relevant company specific appendix. Table 5 below summarises our interventions.

Table 5 Summary of interventions for Northumbrian Water and Dŵr Cymru

| Area of intervention | What we did | Why we did it |
|--|---|---|
| Northumbrian Water | | |
| Outcomes | <p>We have intervened in relation to a limited number of performance commitments and ODIs. Specifically:</p> <ul style="list-style-type: none"> • we increased the performance commitment for overall drinking water compliance; • we removed the reward aspect related to some financial incentives; • we have amended company proposed ‘deadbands’ for a number of delivery incentives; and • we excluded the proposed reputational only incentives related to: (i) maintaining the necessary credit rating; and (ii) efficient and innovative company. | <p>Consistent with our final methodology, we have intervened to ensure that performance commitments – and associated rewards – are sufficiently stretching for the company.</p> <p>In relation to penalty deadbands, we have tightened the band to ensure Northumbrian Water is better incentivised not to allow service to deteriorate below the performance commitment. On the reward side this has primarily involved increasing the deadband to ensure Northumbrian Water can only earn rewards where it demonstrates stretching performance.</p> <p>We do not consider that an incentive mechanism on credit rating is necessary; for consistency with other companies who have not proposed such an incentive, it has been excluded.</p> <p>Similarly, the outcome for an “efficient and innovative company” is a means to delivering its business plan not an outcome in itself.</p> |
| Reconciling 2010-15 performance | <p>We have intervened by reducing the adjustments related to 2010-15 performance. This has the effect of reducing the revenue requirement by £21 million.</p> <p>Northumbrian Water proposed (revenue) adjustments of</p> | <p>We disagreed with the way the company calculated a number of adjustments.</p> <p>In relation to the revenue correction mechanism, the company did not provide sufficient evidence on the need and justification to rebase</p> |

| Area of intervention | What we did | Why we did it |
|------------------------|--|---|
| | <p>approximately £96 million. However, we adopted a different position in relation to the revenue correction mechanism, opex incentive allowance and CIS. The impact is that we have determined legacy adjustments of £75 million.</p> <p>We have also made adjustments to the RCV (and revenue requirement) in relation to a number of outputs from our final determination in 2009 (FD09).</p> | <p>property numbers due to reporting changes.</p> <p>In relation to the opex incentive allowance, we intervened because there is no sustained outperformance associated with one of the schemes.</p> <p>We have intervened in relation to FD09 outputs because either (i) some of the outputs are no longer required or (ii) we do not think, based on current evidence, that Northumbrian Water will deliver all the outputs it was funded to deliver.</p> |
| Retail | <p>We did not adjust the cost to serve for new costs by the full amount the company proposed.</p> | <p>The company did not clearly demonstrate that the new costs were the most cost-beneficial or efficient.</p> |
| Risk and reward | <p>We removed the uncertainty mechanism proposed by the company for new statutory obligations.</p> <p>We amended the company proposal for an uncertainty mechanism for water business rate charges so that 75% of efficient qualifying cost variations assessed in an interim would be passed through to customers.</p> | <p>This intervention protects customers from bearing risks that are not well justified or substantiated.</p> |

| Area of intervention | What we did | Why we did it |
|--|---|--|
| Dŵr Cymru | | |
| Outcomes | <p>We have intervened in relation to a limited number of performance commitments and ODIs.</p> <p>Specifically:</p> <ul style="list-style-type: none"> • we reduced the maximum annual rewards available for some outcome delivery incentives (ODIs) (by about £22 million altogether); • we increased the maximum annual penalties for some ODIs (by about £16.5 million altogether); • we altered two performance commitments so that transferred assets were no longer excluded; and • we excluded the proposed reputational only incentive related to: (i) maintaining the necessary credit rating, (ii) developing our people and (iii) business efficiency. | <p>In some areas the company did not follow the required methodology. Several of the rewards and penalties proposed by the company were not based on customer willingness to pay or cost of delivery, and did not take into account totex efficiency sharing.</p> <p>We also intervened to include transferred assets because customers who are impacted by events such as sewer flooding will not be concerned as to whether the flood came from a pre-existing or transferred asset.</p> <p>Finally, we do not consider that an incentive mechanism on credit rating is necessary; for consistency with other companies who have not proposed such an incentive, it has been excluded.</p> <p>Similarly, we consider that developing our people and business efficiency are inputs not outcomes.</p> |
| Reconciling 2010-15 performance | <p>We have intervened by slightly reducing the adjustments related to 2010-15 performance. This has the effect of reducing the revenue requirement by £2 million.</p> <p>We have also intervened and applied a shortfall RCV adjustment of £32 million.</p> <p>We did not accept the proposed adjustments to the RCV for decisions made at FD09.</p> | <p>We have included a shortfall for water infrastructure serviceability as a result of the poor performance of the company on interruptions to supply over a number of years.</p> |

| Area of intervention | What we did | Why we did it |
|------------------------|---|--|
| Retail | We made a smaller adjustment for doubtful debt driven by deprivation and bill size than the company proposed; and we did not make any adjustment for the cost of debt management (about £9 million altogether). | The company did not include any new material evidence to support the adjustment for the cost of debt management. |
| Risk and reward | <p>We amended the company proposal on uncertainty mechanism for water business rate charges, so that 75% of costs would be passed through to customers.</p> <p>We have not allowed an uncertainty mechanism proposed by the company for wastewater business rate charges.</p> | <p>We consider that a 75:25% customer:company sharing rate provides the right balance between protecting the company from material risks, providing sufficient incentives for the company to minimise costs and protecting customers' interests. The 80:20% sharing rate agreed with South West Water is due to the company's WaterShare scheme.</p> <p>The company did not provide sufficient evidence that it is in customers interests to have specific protection against wastewater business rate charges while other companies bear this risk.</p> |

Final determinations for Northumbrian Water and Dŵr Cymru

We invite comments on these draft determinations by 4 July 2014.

We will take all relevant information into account when setting our final determinations for Northumbrian Water and Dŵr Cymru. Therefore, we will be considering:

- representations from companies and other stakeholders on these draft determinations;

- updated information submitted by companies as requested by us – for example, updated reported actual performance in 2013-14 and projected performance in 2014-15 (set out in figure 1 below), together with any supporting actual information needed to confirm cost allowances for all companies in final determinations; and
- policy that forms part of the wider price control package, which we will publish later in the price control process (set out in figure 1 below).

This process will allow Northumbrian Water and Dŵr Cymru, and their stakeholders, to fully consider and respond to the various components of the price control framework in advance of setting our final determinations. As confirmed in '[Setting price controls for 2015-20 – policy and information update](#)', Northumbrian Water and Dŵr Cymru will receive equivalence of treatment with those companies receiving their draft determinations in August.

Representations on the draft determinations for Northumbrian Water and Dŵr Cymru can be emailed to price.review@ofwat.gsi.gov.uk or posted to:

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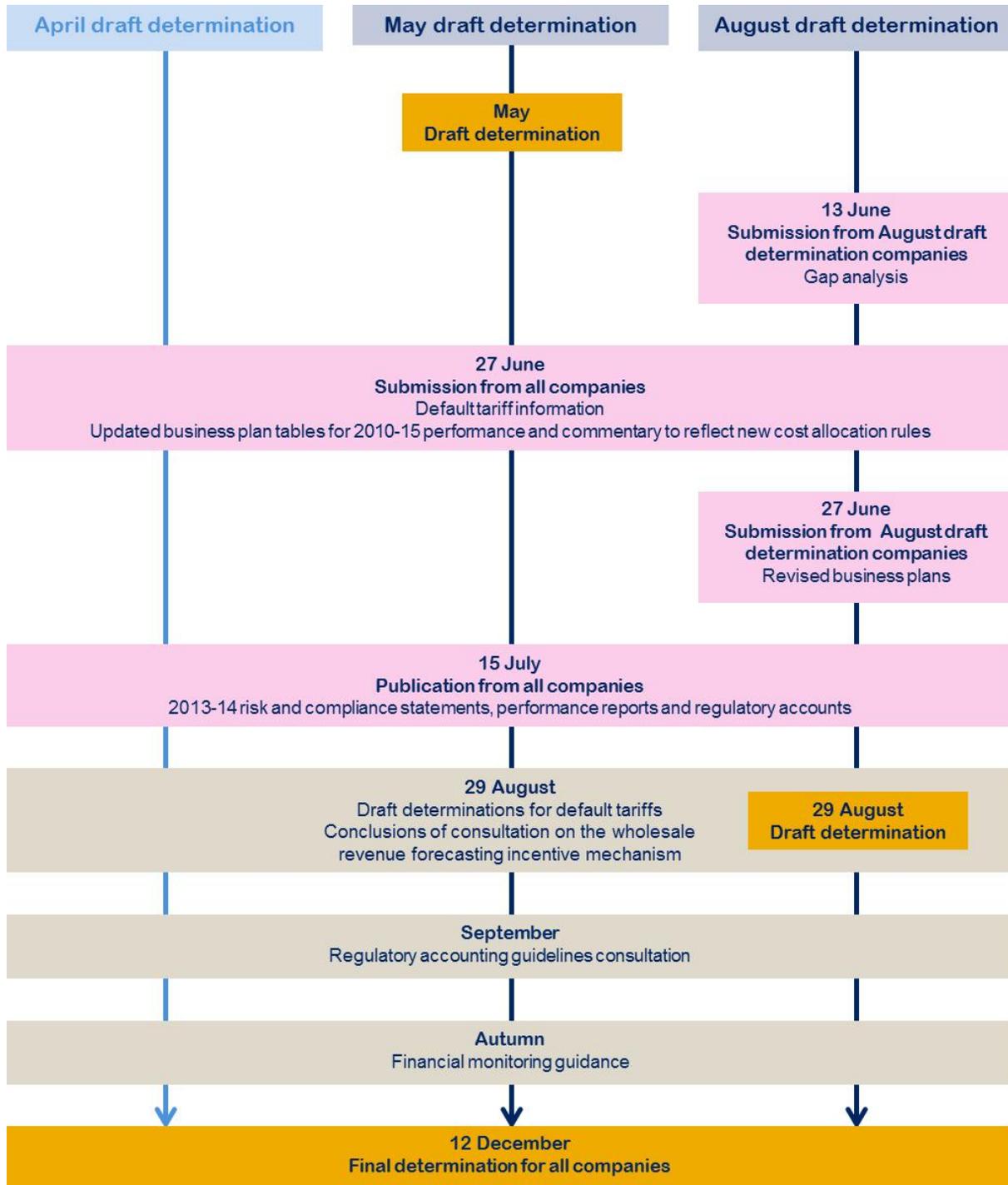
Next steps – relevant to all companies

We have asked the remaining 14 companies to work with their CCGs to address our feedback from the risk-based review and to reflect the risk and reward guidance before submitting revised plans on 27 June 2014. If they do not we will intervene to safeguard customers in line with our price control methodology and supporting guidance.

These interventions may focus on the area of outcomes. We prefer to adopt the proposed incentives on which the companies have engaged with their CCGs. But if companies have not complied with the methodology we will consider targeted and proportionate interventions in order to protect customers. Any interventions would be made to ensure that incentives are effective, with appropriate penalties where necessary, and rewards that can be earned only after the company delivers stretching performance (as set out in '[IN 14/09: 2014 price review – Ofwat's approach to the assessment of risk](#)').

The remaining steps in the 2014 price review for all companies are summarised in figure 1 below.

Figure 1 Remaining steps of the price review process



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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Photograph © freepixels.com
Printed on 75% minimum de-inked post-consumer waste paper
May 2014

ISBN 978-1-908116-76-5

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