August 2014

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

# Overview

This document summarises the draft price controls we have published for 14 water and sewerage and water only companies in England and Wales. These complement the four earlier draft price controls we published for South West Water and Affinity Water (announced in April) and Dŵr Cymru and Northumbrian Water (announced in May).

The draft price controls for all 18 companies, if implemented, would result in average bills for water and wastewater customers in 2015-20 that are 5% lower than in 2010-15 in real terms. At the same time customers would benefit from better levels of service and improvements as a result of substantial expenditure of more than £43 billion.

Companies have engaged directly with over a quarter of a million of their customers, the biggest ever programme of engagement in the sector. Companies' boards have taken real ownership of their business plans and focused on delivering the outcomes that their customers want for today and for the future, including protecting the environment. We see this as a step in the right direction to maintaining and building trust and confidence in a sector that delivers an essential public service.

As part of the draft price control process we have challenged the proposals the companies put forward and have intervened where we consider it necessary to protect customers.

In reaching this point in the process, the companies and Ofwat have considered carefully their statutory responsibilities, including environmental and water quality responsibilities. We have developed the draft determinations in line with our final methodology and our statutory duties. We have also had regard to relevant guidance from the UK Government, and the Welsh Government and the principles of best regulatory practice to be transparent, accountable, proportionate, consistent and targeted.

## Getting the best deal for customers

Three key factors have helped ensure the best deal for customers.

- **Most companies put forward lower bills in the business plans that they submitted in June (with the exception of two companies).** Most companies listened to their customers' concerns regarding the cost of living and took the views of their customers into consideration when producing their plans. Different companies adopted different approaches including capturing views of vulnerable customers (including customers on low income and those with disabilities) in surveys and running targeted focus groups for vulnerable customers. Companies are proposing a range of measures to support customers who are likely to experience affordability problems including the provision of social tariffs offering discounts to those customers. Some propose working closely with social housing and money advice providers and providing bespoke home water efficiency audits to ensure that vulnerable customers received expert advice and help with affordability issues. Overall, companies have shown a step change in the way they engaged directly with customers, working with the independent customer challenge groups (CCGs), to deliver better quality plans that reflect their customers' priorities.

- **We have consistently applied the principles set out in our final methodology to get the best possible deal for customers.** For this price review we have transformed the way we set price controls. We have done this in a number of ways. For example, we have moved from basing our efficiency challenge to companies on the average efficiency measure that we used in the past to a more stretching upper quartile challenge of efficiency; this change tightened the cost threshold against which we challenged companies by more than £3 billion.

- **We have maintained a high evidential bar when assessing the business plans and we have intervened where necessary to ensure that customers are protected.** For example, in December all companies put forward a cost of capital that was higher than market evidence suggests it should have been. We issued our risk and reward guidance as a result, setting out our expectations on the cost of capital. As a result, a number of companies reflected our expectations of the cost of capital in their revised June plans. We intervened where they did not do so. This has resulted in savings for customers in excess of £2 billion by 2020.

## Ensuring customers are protected

Through the development of their business plans, companies have worked hard to strengthen their relationships with their customers. We have seen companies owning the plans and reflecting the local and regional priorities of their customers far more than before. Where we have been satisfied on the basis of the evidence provided to us that companies are doing the right thing for their customers, we have not stepped in to intervene in their plans. But where we have not been satisfied, we have intervened as necessary to protect customers. In doing so, we have taken all appropriate measures to protect customers' interests while at the same time ensuring that an efficient company is able to raise the money it needs to invest to maintain and improve services.

The scale and scope of the interventions we have made vary across the 14 companies, some with moderate interventions, and others to address more significant concerns. As a result, the draft price controls for these companies are different from the draft price controls we published for the two enhanced companies (South West Water and Affinity Water) and from the two early draft price controls (Dŵr Cymru and Northumbrian Water) where we considered limited intervention was required. For all 18 companies we have consistently applied our final methodology and principles of targeted and proportionate price control regulation.

## What happens next

The material we have published today sets out our draft proposals. Stakeholders now have the opportunity to comment on the proposals and the approach we have adopted in reaching our decision **by 10am 3 October 2014.** We will consider carefully all of the representations ahead of making final determinations in December 2014. In particular, companies will review whether to include further evidence as a result of the feedback we have given them. And we will maintain our high evidential bar to make sure that our final decisions represent the best possible deal for customers.

It is for companies then to decide each year the level at which they will set charges for customers consistent with our final determinations. The first charges they will set consistent with our December 2014 final determinations will come into force in April 2015.

# Delivering the best deal for customers

Overall, the business plans that companies have put forward at this price review take much greater account of customers' views on what matters the most to them. Companies have invested significant time and effort to prepare higher quality plans which will result in more than £43 billion of expenditure while remaining affordable for their customers. Over the next five years our draft determinations include commitments to deliver:

- an average 40% reduction in the time lost to supply interruptions;
- a reduction of 1,200 incidences of internal sewer flooding by 2020;
- cleaner water at more than 50 beaches. A target of zero serious (category 1 or 2) pollution incidents, with other pollutions incidents dropping by around a quarter; and
- a saving of at least 340 million litres a day by tackling leakage and promoting water efficiency – enough water saved to serve all of the homes in Birmingham, Liverpool and Leeds. A target of 100% compliance on drinking water quality.

Throughout this price control process we have encouraged constructive dialogue with the companies in order to reach the best possible outcome for customers. The risk-based review provided feedback on the quality of the initial business plans that the companies submitted in December and areas that required attention. Most companies have positively engaged with us and as a result, we saw an overall improvement in the quality of the revised plans that were submitted in June.

## Our methodology

Our final methodology introduced a number of significant changes to the way in which companies run their businesses and how we regulate. We are:

- requiring companies to focus on delivering outcomes, with performance commitments and delivery incentives;
- placing greater emphasis on company ownership of plans through direct engagement with customers to understand their priorities and willingness to pay for specific outcomes, and through the provision of board assurance;
- setting four separate price controls, covering retail activities for household and non-household and wholesale water and wastewater activities;

- encouraging high-quality plans and delivering a proportionate approach through the risk-based review which saw two companies receive early draft determinations as enhanced companies;
- for wholesale, we are using a total expenditure approach (totex) to enable and encourage companies to develop more innovative cost solutions;
- for retail household, using an average cost to serve challenge to determine the allowed costs; and
- applying an upper quartile efficiency challenge on all companies' wholesale costs and using a high evidence threshold to review companies' wholesale cost claims.

Through the draft determinations we have seen this methodology delivering real benefits for customers, including the environment now and for the future. We expect companies to build further on this ahead of the final determinations as they review our draft determinations and respond to the challenges we have raised.

### We have set a high evidential bar

Our duty is to protect customers' interests and to ensure that an efficient company is able to finance its functions.

In order to discharge our duty, we have been clear that proposals put forward in the companies' business plans must meet our high evidential bar, satisfying us that a company is delivering what its customers want at a price they can afford. We have only intervened where this evidential bar has not been met. We have placed the onus on companies to assure us that their plans are financeable. But where we have intervened to change those plans we have taken into account the need to ensure that an efficient company is able to raise the money it needs to invest to maintain and improve services.

The scale and scope of the interventions we have made vary across the 14 companies, for some we have made moderate interventions, and for others our interventions have been more significant. A number of companies provided high quality evidence to support their proposals and gave us confidence that the plan would deliver what their customers wanted at a price they could afford, in a way that was efficient and financeable. In these plans we have made only a small number of interventions. Where we did not receive the evidence to support proposals we have intervened more substantively in accordance with our methodology.

The draft price controls for these 14 companies are different from the draft price controls we have already published. South West Water and Affinity Water produced excellent plans which required no material interventions and were therefore awarded enhanced status. These companies have been in a position to begin work to deliver their plans since April 2014. 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, would receive an early draft determination. Both companies submitted plans that deliver the outcomes that their customers want and can afford. In a small number of instances we had to intervene to protect customers.

Even after our interventions, for a number of companies our draft determinations are largely unchanged from their business plan proposals. Overall, we are allowing 96% of the revenues set out in company business plans. This reflects the work that companies have done in engaging with customers, working with their CCGs, and challenging themselves before the submission of their plans to us.

Although there are a number of factors that drive differences in revenue allowance, our interventions on wholesale water and wastewater costs are a key driver of the difference between draft determination revenue and company plans. Around 80% of the value of interventions relate to wholesale costs.

Table 1 summarises our key interventions across all areas of the business plans. All of our proposed interventions have followed the final methodology and subsequent guidance, where relevant, to ensure they were implemented in a consistent way across all companies.

We expect to retain greater scrutiny of those companies that required substantial, or repeated, interventions to protect customers' interests and to adopt an oversight and monitoring regime that is flexible to allow for improvements in company performance and assurance.

## Relationship with earlier PR14 draft determinations

When we made our early draft determinations for Northumbrian Water and Dŵr Cymru, we said that they would receive equivalent treatment to companies receiving draft determinations now. They would neither gain nor lose as a result of receiving their draft determinations earlier (beyond the benefit from the earlier draft determinations themselves). Although we are not publishing fully revised draft determinations for these two companies, we have published draft determinations for their non-household retail price control (which we have not provided for any companies previously) and our approach to interventions in areas such as the horizontal checks on outcomes, will apply to them equally.

For South West Water and Affinity Water, companies with enhanced status, our approach is different. For these companies we committed to a ‘do no harm’ approach (as detailed in ‘Setting price controls for 2015-20 – decisions on enhanced companies and next steps’) so they are not penalised for submitting high quality plans and receiving an early draft determination. Consequently, the extent to which any changes will apply to these two companies will be different to Northumbrian Water and Dŵr Cymru.

**Table 1 Key areas of intervention within price controls**

| Issue | Our intervention | Why we intervened |
|---|---|---|
| **Outcomes** | | |
| Delivering upper quartile performance | For a small number of outcomes and performance commitments/ODIs we were able to compare proposals across the sector. We ensured that performance commitments and incentives targeted upper quartile performance. | One of the key principles for outcome incentives is the need to ensure that companies are appropriately rewarded for outperformance, while at the same time avoiding situations where companies can gain financially for delivering a level of performance that is not stretching. |
| Overall financial impact of incentives | We propose introducing an overall aggregate cap on the potential impact of incentive penalties and rewards. | The newness of outcomes and limitations in the comparability across the incentives companies proposed mean there is some risk that customers and companies could be exposed to excessive rewards and penalties. The aggregate cap is a way of mitigating these risks. |
| **Wholesale costs** | | |
| Only allowing efficient level of expenditure in price controls | We only allowed our view of the efficient level of total expenditure in price controls for each company. We only adjusted this amount where companies could provide evidence to demonstrate that our view needed to be amended to reflect the specific circumstances of the company. | Wholesale water and wastewater expenditure is the major driver of customer bills. Our interventions ensure that we only allow the efficient level of expenditure companies need to deliver services to customers. |

| Issue | Our intervention | Why we intervened |
|---|---|---|
| Ensuring incentives for submitting high quality plans are proportionate and protect customers interests | Where our view of the efficient level of expenditure was higher than a company proposed we capped the difference at 5%. | We are protecting the interests of customers by limiting the short-term benefit to companies. But companies retain incentives to submit high-quality proposals, which benefits customers in the long term through more efficient companies. |
| **Retail price controls** | | |
| Ensuring companies have allocated costs correctly | We are requiring some companies to submit further evidence to support their allocations of costs before we make our final determinations. Failure to provide sufficient evidence will mean greater assurance on costs will be required during 2015-20. | We are ensuring that each price control properly reflects the cost of delivering the relevant services, helping to focus companies on delivering services to customers more efficiently. |
| Only allowing efficient costs | We reviewed company claims to adjust the cost to serve against a high evidential bar. We only allowed an adjustment where a company provided sufficiently convincing evidence to meet our assessment criteria | Our interventions ensure that we only allow the efficient level of expenditure companies need to deliver services to customers. |
| **Risk and reward** | | |
| Ensuring that the cost of raising finance is appropriate | We set out in our risk and reward guidance that market evidence supported a lower cost of capital than companies proposed in their original plans in December 2013 | Efficient companies need to be able to finance their functions, but we must protect customers by only allowing companies to earn returns that reflect the risk that companies face. |

| Issue | Our intervention | Why we intervened |
|---|---|---|
| Ensuring the cost of raising finance for small companies is appropriate | We only allowed uplifts to the cost of capital where smaller companies could demonstrate both that they face a higher cost to raising finance and that there is an offsetting benefit to customers | Efficient companies need to be able to finance their functions, but we must protect customers by only allowing companies to earn returns that reflect the risk that companies face. |
| **Financeability and affordability** | | |
| Passing on the benefits of a lower cost of capital | We are asking companies to work with customers to better explore the extent to which the benefit of a lower cost of capital should pass to customers in the period 2015-20 (rather than in future periods). | Because we are using a lower cost of capital than companies proposed we want to ensure that customers benefit from this where it is appropriate to do so. |

# Delivering what customers want

For this price review, companies' boards have taken real ownership of their business plans and focussed on delivering the outcomes that their customers want for today and for the future, including protecting the environment.

The key results of our review of the companies' business plans are as follows.

- Companies have put forward 399 outcomes with associated performance commitments. Companies listened to their customers' preferences in relation to the outcomes they wish to see and how much they are willing to pay for those outcomes.

- In our final methodology we said we wanted companies to take more ownership of – and accountability for – what they deliver for their customers. In response, companies are changing the way they think about service levels and outcomes performance, and providing incentives to improve performance.

- Where customer benefits from company proposals are not clear, we have intervened in a way which maintains incentives to improve performance, while protecting customers. We have developed a series of interventions that are designed to maintain both the strength of our cost challenges and incentives on companies to improve performance.

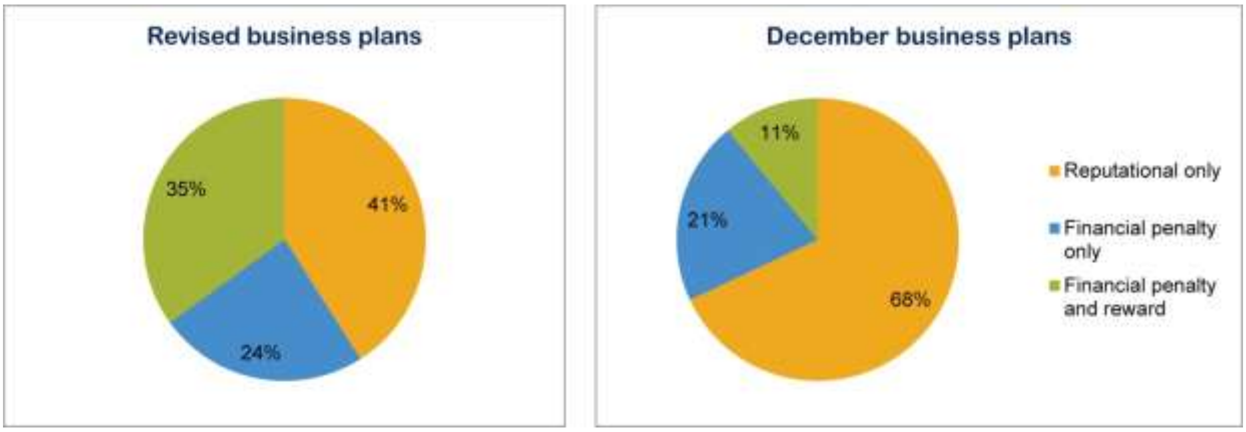
In addition to the near term benefits to customers of improved outcomes, the approach we have adopted will reveal valuable information on companies' ability to deliver various outcomes. This will allow even greater benefits to customers in subsequent price control periods, as the information can be used to sharpen and target the incentives.

## Company proposals

Companies have engaged directly with their customers to develop a set of **outcomes** and associated **performance commitments** (PCs) and **outcome delivery incentives** (ODIs). This is a substantial change from previous price reviews, which saw us as the regulator prescribing outputs or outcomes. Independent CCGs scrutinised the quality of companies' engagement with customers and the extent to which the business plans they put forward reflect customers' views.

Some 59% of the performance commitments associated with outcomes had financial ODIs attached (35% were financial rewards and penalties; 24% were penalty only) to incentivise companies to deliver what customers have said they are willing to pay for. We observed a significant change in the make-up of the incentives between the original December business plans and the revised June plans with a shift from reputational to financial incentives. Figure 1 highlights this.

**Figure 1 Change in form of incentives between December and revised plans**[1]




## Our assessment

Our approach to assessing company proposed outcomes, PCs and ODIs reflects the fact that the final methodology gave the companies considerable freedom regarding their approach to incentives. Leakage and the service incentive mechanism (SIM) were the areas in which all companies were required to include an incentive.

[1] The figure represents proposals as at the time that company revised plans were submitted on 27 June. They cover all 18 companies (including those that submitted before 27 June).

Providing companies had engaged directly with customers and followed their expressed priorities and willingness to pay, companies could propose bespoke incentive packages in the style of their choosing. In order to protect the interests of customers, proposed performance levels needed to challenge or stretch the companies. Financial incentives containing rewards for out-performance and/or penalties for underperformance had to reflect customer priorities and be justified by customers' willingness to pay.

We checked to ensure that all key areas of expenditure were covered by performance commitments within a company's package of outcomes.

We completed **bottom up analysis** of all company proposals, recognising the bespoke choices companies made. Our analysis was consistent with our internal methodology from the risk-based review, focusing on the evidence provided on value for money, stretch within the proposed performance levels, and the choice and detailed structure of the proposed incentives.

Part of this bottom up analysis involved undertaking a number of consistency checks across different areas of companies' business plans to ensure that the proposed incentives protect customers against risks of under-delivery. We:

- assessed consistency with wholesale cost special claims;
- checked against assessed performance in 2010-15; and
- checked the consistency of approaches regarding asset health incentives.

Where we identified concerns we intervened to remove or amend company proposals, or we asked companies to reconsider their proposals in light of our assessment.

The first time that we were able to review and understand the proposed outcomes and financial incentives across the whole sector was at the end of June. We checked the **consistency across company proposals through 'horizontal checks'** for six specific areas where it was possible to make direct comparisons between company proposals.

We found that company proposed financial incentives were not always matched by performance commitments consistent with upper quartile performance. Company wholesale water and wastewater expenditure incentives are calibrated to achieve upper quartile efficiency during 2015-20. This means we would expect companies to deliver upper quartile performance on service delivery where this can be identified, to ensure customers' interests are protected.

Where this was not the case we intervened – allowing a two-year glide-path to reach this point (which reflects the challenges faced by some companies in making the changes necessary to deliver this higher standard of performance against the need for customers to see benefits as soon as possible).

Given the limited comparability of a significant number of the proposed incentives, we considered the overall proposed packages of financial incentives for each company. We have judged that it is appropriate to introduce an **overall aggregate cap**, in order to protect customers. Such an approach reflects the constraints that many companies face delivering a range of outcomes within a constrained financial package.

Recognising the innovative nature of our approach on outcomes and incentives, we propose to implement a cap and collar of ±2 percentage points of return on regulatory equity (RoRE) a year on total rewards and total penalties for each price control element.

The aggregate cap and collar will be calculated and applied over the five years of the price control, so netting off (effectively averaging) between years will be permitted. Netting-off between rewards and penalties in relation to different outcomes will not be permitted because this would dull the incentive to deliver specific outcomes and could mean that companies avoid a penalty when they do not meet a performance commitment.

The company and/or the CCG could apply to Ofwat to amend the cap and collar in the event that they consider the arrangement was working against the interests of customers.

We expect all companies to demonstrate that their PCs can be measured and recorded consistently, and that they will have the appropriate governance and quality assurance processes in place to achieve this. Companies must be transparent with customers about their performance against their outcomes and commitments. For the draft determination we have identified areas where we think companies can improve further on their proposed approach.

We expect companies to demonstrate how they are addressing our concerns ahead of the final determination.

# Securing value for money: Wholesale

The cost of delivering wholesale water and wastewater outcomes is a major driver of customer bills, comprising more than 90% of the value chain. At this price review we are using a total expenditure (totex) approach for the first time to address concerns about a bias towards capital expenditure over operational expenditure and encourage companies to develop innovative cost solutions.

The key results of our review of the companies' business plans are as follows.

- Some companies have reduced their proposed expenditure since December. Others have increased the scope of what they propose to deliver. The gap between our draft determination threshold and company proposals for wholesale totex is considerably closer than in December.

- We tightened the cost threshold against which we challenged companies by more than £3billion due to (a) our approach of using an upper quartile rather than an average efficiency challenge on all companies' wholesale costs and (b) our high evidence threshold for companies' special wholesale cost claims.

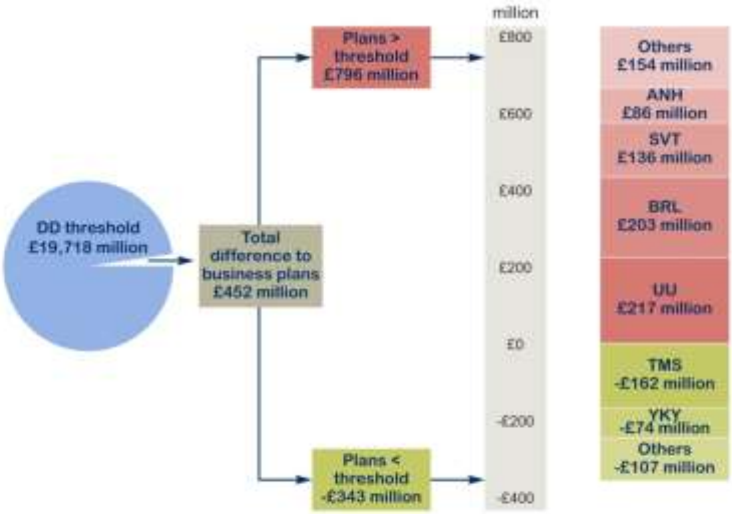
- We have intervened where the claims for special costs have not passed the relevant gates we set, but the scale of our interventions is significantly reduced from the risk-based review, reflecting companies' work to respond to our feedback in submitting their revised plans. There remain material gaps between our draft determination thresholds and company proposals for three outlier price controls.

We have accepted over 96% of the wholesale expenditure in the companies' business plans overall. We have seen a number of companies putting forward ambitious plans which improve services, protect the environment and reflect value for money for their customers.

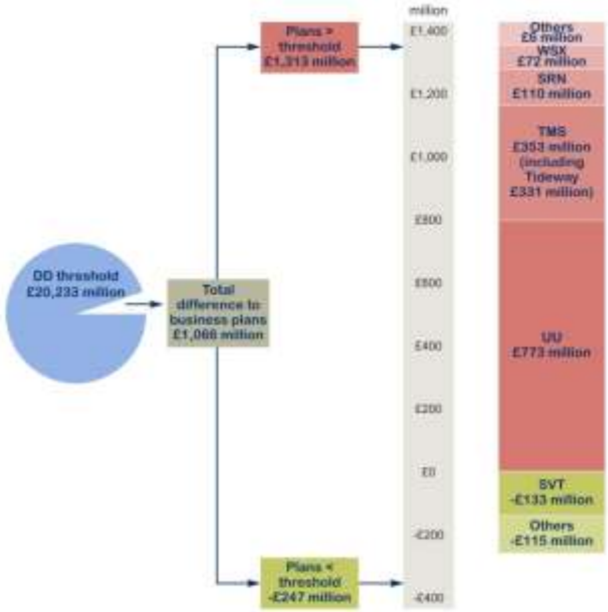
Figures 2 and 3 set out the gap between our view and the companies' view on wholesale water and wastewater expenditure. For water, our view of costs was £452 million lower than companies' proposed. However, there was substantial variation across companies with some submitting costs lower than our view; Thames Water being the lowest compared to our view at £524 million (before we applied the 5% cap that we describe below, which reduced the difference to £162 million), and others submitting costs above our view, United Utilities showing the greatest difference at £217 million.

For wastewater, our view of costs is £1.1 billion lower than companies' proposals. Again this varied substantially between companies, with some being below our view of cost, Severn Trent Water the lowest compared to our view at £342 million (before we applied a 5% cap which reduced the difference to £133 million), but others above, United Utilities being highest above our view at £773 million.

### Figure 2 Wholesale water totex allowance differences compared with business plans




### Figure 3 Wholesale wastewater totex allowance differences compared with business plans



We considered all of the evidence companies submitted to us to explain why our view of costs may not properly account for their circumstances. We accepted some companies' explanations, but we rejected a number of claims. In some cases, this was because we concluded that our view of costs already covered the claim. In other cases, companies could not provide evidence to demonstrate that:

- expenditure was needed during the period 2015-20;
- the proposals were cost beneficial and based on robust cost estimates; and
- that customers would be protected if, for example, a company fails to deliver a specific scheme.

The impact of these judgements reflects the gap between our view and the company plan, illustrated in table 2.

**Table 2 Gap between company revised plans and draft determination view of cost**

| | % gap | |
|---|---|---|
| | Water | Wastewater |
| Anglian | 5 | -1 |
| Severn Trent | 5 | -5 |
| Southern | 6 | 6 |
| Thames (excluding Tideway) | -5 | 1 |
| United Utilities | 10 | 29 |
| Wessex | 4 | 7 |
| Yorkshire | -5 | 0 |
| Bristol | 57 | – |
| Dee Valley | 12 | – |
| Portsmouth | -3 | – |
| Sembcorp Bournemouth | 3 | – |
| South East | 5 | – |
| South Staffordshire | 3 | – |
| Sutton & East Surrey | 3 | – |

For our draft determinations we used our view of cost to determine the expenditure allowance in price controls, before the application of the menu.

This means that some companies receive less revenue than they proposed in their plan. This does not indicate that specific schemes or activities do not need to be delivered but that we require additional evidence to satisfy ourselves that customers should pay for them. Companies can respond to our decisions and provide additional evidence ahead of final decisions.

These companies have the opportunity to understand our decisions and submit additional evidence to support their claims in their representations. If there remains a difference between our view of costs and the companies' views this does not translate fully into a difference in allowed revenue, because we derive the menu baseline by combining our estimate of efficient costs with the companies' forecasts in the ratio 75:25.

For some companies this gap is significant. On 6 August, we published a document that explained that for three price controls for three companies the gap was greater than 20%. These were for

- United Utilities' wastewater price control (a gap of £773 million);
- Thames Water's for Thames Tideway Tunnel costs (£331 million); and
- Bristol Water's water price control (£203 million).

For these three companies we published our assessment in these areas early to give the companies as much time as possible to address the outstanding issues.

For companies with a negative gap (that is our view of costs is higher than the company's) we also used our view of costs to determine the expenditure allowance. These companies receive more revenue for either wholesale water or wastewater costs than proposed in their plans. However, we intervened if the gap was greater than 5% by capping the difference at 5% above the company proposed level of expenditure.

We consider that a cap of 5% above company business plan view of totex provides a strong protection for customers. At the same time, our approach recognises that companies that submit cost efficient plans should benefit from the incentives we put in place to encourage high-quality submissions and that customers will benefit in the long term from the movement in the industry frontier efficiency from these cost efficient plans.

While companies have responded to our risk-based review with additional information to help us understand where our modelled cost allowances may not be sufficient, there is less information available to us to understand where our models may over-estimate the costs of an efficient company. The proposed cap ensures that we place greater weight on companies' own business plan proposals in setting price limits where there are such significant 'negative gaps'.

We explained in chapter A2 of our enhanced draft determination technical appendix that, for the enhanced companies South West Water and Affinity Water we used company forecast variables in our calculations, capping the gap between South West Water's wholesale water plan and our view.

Our decision at that time reflected the particular circumstance of those two companies and their position as enhanced companies. We said we would consider the need to adapt our cost thresholds on a case by case basis. The gaps for the two early draft determinations of Dŵr Cymru and Northumbrian Water were around 4% compared to our threshold. These companies are therefore not affected by our decision to introduce a 5% cap.

Using this approach, of the 14 companies, we capped expenditure for Thames Water and Yorkshire Water for the water price control and Severn Trent Water for the wastewater price control.

## Adjustments for performance during 2010-15

When we last set price controls in 2009 we included a number of incentive mechanisms to encourage companies to improve and deliver services more efficiently and to manage uncertainty. These mechanisms were part of our PR09 methodology (and determinations in 2009) and the reconciliation of the incentives would take place at this price review. Companies have had to report their performance against these mechanisms and set out any proposed adjustments to 2015-20 price controls as part of their business plan development.

We have compared each company's view of its performance against these mechanisms with our assessment. Where our assessment of the adjustments matched the company's view, we have not intervened, but we identified some companies where we needed to intervene because:

- the company had not allocated revenue appropriately between rewards and penalties (to the detriment of customers); or
- we disagreed with the company's assessment of its performance and were not convinced by the supporting evidence.

While we have intervened across all of the tools, our main interventions have been with the SIM, revenue correction mechanism (RCM) and capital expenditure incentive scheme (CIS) and in relation to serviceability, (serviceability monitors whether the companies are maintaining the flow of service to customers and whether the assets are being maintained for current and future customers). In PR09 we said that we would adjust company price controls through the 'shortfalling' process to reflect where companies are delivering a less than stable level of serviceability.

Our interventions reduce industry revenue by £192 million and industry regulatory capital value RCV by £360 million compared with companies' plans.

# Securing value for money: retail household

The 2014 price review sets the first separate price controls for customer facing ‘retail’ services for households. The household retail costs included in companies’ business plans for 2015-20 are £4.1 billion. These retail controls ensure that customers have an appropriate level of protection on service and price. By setting separate controls for household customers and non-household customers we have distinguished between customers that do not have a choice of supplier and those that do.

Overall our challenges to companies’ retail costs will save customers £0.9 billion between 2015 and 2020[2]. The key results of our review of the companies’ business plans are as follows.

- Since December companies have made reductions to their retail household costs totalling £59 million and better allocated their costs across customer groups. Companies have also committed to continuing to provide service level protection for customers through the SIM.[3]

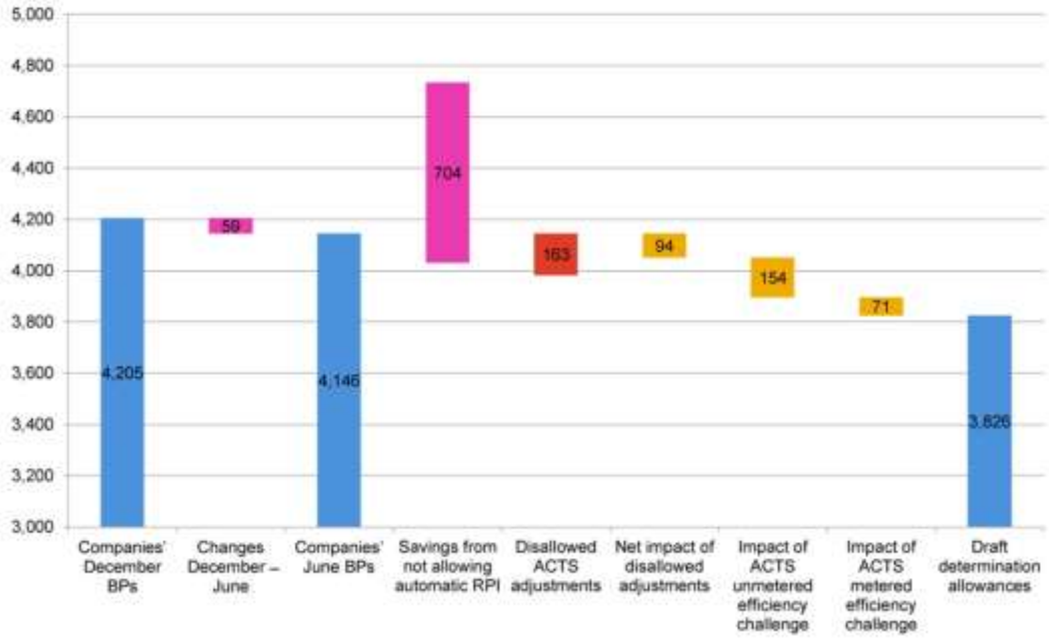
- Applying our average cost to serve (ACTS) efficiency challenge and not automatically indexing retail price controls to the Retail Prices Index (RPI) will benefit customers in the period 2015-20 as a result of the downward pressure we have brought on customers’ bills.

- We have made interventions worth £163 million to customers on company claims for bad debt, input price pressure and new costs.

Figure 4 shows the change in costs between plans and the draft determination and the impact of our interventions.

[2] The total savings for household retail are arrived at by comparing June business plans, less requests for input price pressure allowances plus forecast RPI, with the draft determination allowances. This difference is £909 million.
[3] In ‘Service incentive mechanism (SIM) for 2015 onwards – conclusions’ we set out how we propose to regulate using the SIM in the future.

**Figure 4 Difference between company and Ofwat view of household retail costs[4]**




## Company claims to adjust cost to serve

Some companies proposed adjusting the cost to serve to reflect the impact of specific factors, which they argued distorted their cost to serve in the next control period. But on the whole, most companies were unable to meet our high evidential bar. Of the 14 companies that submitted business plans in June:

[4] All figures taken from companies' plans/our assessments. Figures shown in 2012-13 prices and include all companies (including those receiving early draft determinations). RPI savings figure is an estimate based on our independent advice of forward projections of RPI applied to companies' plans minus input cost pressure claims to avoid double counting – this overlaps the companies' June business plans column on the chart as some companies had included an allowance for inflation in their business plans. Disallowed ACTS adjustments include adjustments for pension deficits and new costs requested as adjustments. As rejecting a company affects the ACTS, and hence allowed revenues across the industry, the net impact of disallowed adjustments is shown separately. ACTS efficiency challenges are applied after removing ACTS adjustments.

- five companies argued for adjustments to reflect the impact of **bad debt**. Of the companies receiving draft determinations today, we only allowed adjustments for one company – United Utilities. It was able to demonstrate that the impact of bad debt was material, beyond management control and that it was materially different from the rest of the sector;
- ten companies argued for adjustments to reflect the impact of **input price pressure**. We have only made an adjustment for Yorkshire Water, subject to us receiving further assurance on its allocation of costs. Yorkshire Water was the only company to demonstrate that the impact was material, beyond management control and that it was materially different from the rest of the sector as it was delivering upper quartile performance; and
- six companies included material **new costs** in their business plans that they expected to incur but which were not taken into account in historic costs to serve data. We only allowed material new costs for one company, Anglian Water. Anglian Water's claim demonstrated a clear need, provided cost benefit analysis and robust costs. It linked each investment to customer benefits. Customers are further protected through the SIM. We also included cost increments for Severn Trent Water, Thames Water and United Utilities but will be seeking further evidence for these companies ahead of final determinations.

# Securing value for money: retail non-household

The 2014 price review sets the first separate price controls for customer facing ‘retail’ services for non-households. The non-household retail costs proposed in companies' business plans for 2015-20 are around £580 million. For all 18 companies, we have published our draft determinations for average revenue controls for non-household retail services.

## Promoting choice for the benefit of customers in England

Our 2014 price review sets, for each company, a separate, binding average revenue control for ‘retail’ services for all non-household customers. Our proposals assume that, in line with UK Government policy, non-household customers in England will have the ability to choose their retailer from 1 April 2017.

The default tariffs that companies in England set will provide a comparison point for customers, so they can clearly see whether they would be better off changing their supplier, helping to maximise the benefits for customers of the retail market reforms provided for by the Water Act 2014.

The key results of our review of the business plans of companies operating wholly or mainly in England are as follows.

- Since December companies have revised their non-household retail proposals. This has involved many companies undertaking in-depth cost allocation exercises.

- Overall, our methodology will help facilitate a competitive market, while ensuring suitable protection for customers. Our approach has given companies flexibility in developing their non-household retail proposals. This will help the retail market for non-household customers develop from 2017.

- We have challenged companies’ plans where they have provided insufficient evidence to ensure that customers continue to be protected. In total, we have challenged companies’ non-household retail proposals by £54 million (10%) over 2015-20. We have not intervened in the cost and net margin allocations proposed in the non-household retail business plans in England. However, we have published an information note setting out our expectations for draft determination representations in relation to potential changes to the length or form of the non-household retail controls. We have also asked companies to provide evidence of engagement with non-household customers.

Each company is responsible for ensuring that its own default tariffs are set appropriately (including that they comply with competition law). We invite companies to consider whether they would prefer the non-household controls to be set for five years, or the form of the control to be amended in some way that would allow greater time for them to address any issues with their cost and net margin allocations.

## Protecting customers in Wales

For companies operating wholly or mainly in Wales, consistent with our final methodology, we have taken a different approach. This reflects the fact that, in line with Welsh Government policy, customers in Wales using less than 50Ml of water will not be able to choose their supplier during the next five years.

The key results of our review of the business plans of companies operating wholly or mainly in Wales are as follows.

- Since December companies have revised their non-household retail proposals. Dŵr Cymru is seeking to deliver some £2.5 million of cumulative efficiency savings over the period 2015-20.

- We have applied a regulatory efficiency challenge based on a comparison with equivalent tariffs available to customers in England. To ensure that customers in Wales will also continue to receive high quality service where they cannot shop around, we are including a non-household SIM for companies operating wholly or mainly in Wales.

- We have intervened in the tariff structures of Dee Valley Water, which were poorly developed and not supported by evidence.

Companies operating wholly or mainly in Wales are also responsible for ensuring that their default tariffs are set appropriately (including that they comply with competition law) - notwithstanding the fact that few customers will have choice of their retail supplier.

# Balancing risk and reward

As we set out in our risk and reward guidance, high-quality business plans will include appropriate risks, rewards and penalties. Effective rewards and penalties benefit customers by providing meaningful incentives to provide the best service and by ensuring that risks are allocated to companies where they are best placed to manage them. The overall level of return (based on companies' expected performance) has a direct impact on customer bills.

The key results of our review of the companies' business plans are as follows.

- All companies except one have accepted our risk and reward guidance on weighted average cost of capital and net margins in their June plans.
- Our draft proposals, if implemented, would save customers in excess of £2 billion over the period 2015-20, relative to companies' proposals at the risk-based review.
- We have intervened in two areas.
  - All water only companies except one have sought a small company uplift. We are only allowing small company premiums for the two efficient companies for whom the benefits exceed the costs.
  - We have reduced price risk for customers by only allowing uncertainty mechanisms for water business rates and a specific mechanism for the Thames Tideway Tunnel.

We expect companies with high-quality business plans to be able to demonstrate how risk will be dealt with and how rewards and penalties will be set to incentivise outperformance. We expect companies' plans to contain a package of risk, reward and penalties that works for their investors, and we expect them to be able to demonstrate to us that this represents a good deal for their customers.

We set out our view of what an appropriate risk and reward package might be when we published our guidance on risk and reward in January.

The draft determinations will enable **investors to earn returns that reflect the risks** they are taking provided the companies deliver on their plans and commitments. And the **companies will be able to share additional rewards with their customers if they outperform** the targets set out in their plans.

We were pleased that all companies, with the exception of Dee Valley Water, adopted our guidance for **retail household** (1%) and **non-household retail margins** (2.5%). We saw no convincing evidence to change our view and so have applied these margins for all companies.

Similarly, for the wholesale **cost of capital,** all companies providing both water and wastewater services accepted the 3.7% **cost of capital** set out in our risk and reward guidance. All but one of the water only companies argued for an uplift to the cost of capital.

In our draft determinations we have applied a cost of capital of 3.7%, consistent with our risk and reward guidance. We will review the cost of capital in our final determination to take account of market and regulatory developments.

We allowed a small uplift to the cost of capital for two small water only companies where we were satisfied that they faced a higher cost to raising finance and that there was an offsetting customer benefit. We concluded that the evidence supported a higher cost of debt of 0.25%, equivalent to an uplift of 0.15% on the cost of capital for these two companies.

This acceptance of the cost of capital and retail margins from the risk and reward guidance could see benefits to customers in excess of £2 billion over the period 2015-20. But, it is not clear that companies have engaged with their customers about how these savings are shared between current and future customers. As a result, we have asked some companies to engage with their customers again to consider the trade-offs between current and future customers in relation to their passing on the benefits of a lower cost of capital. We have intervened in Yorkshire Water’s and Sembcorp Bournemouth Water’s plans. Yorkshire had removed all of the impact of the weighted average cost of capital (WACC) reduction in 2015-20 with little evidence that this was beneficial to customers. Sembcorp Bournemouth Water had maintained higher bills in 2015-20 to maintain a stable bill profile over 2015-25 (two price control periods) with little evidence this approach is beneficial, or has the informed support of customers.

We will continue to challenge to ensure the best possible outcome for customers. When we make our final determinations in December 2014, we will consider the latest market evidence to ensure that the applied cost of capital remains appropriate. We note that current market evidence suggests a downward movement in the cost of debt since we issued our risk and reward guidance.

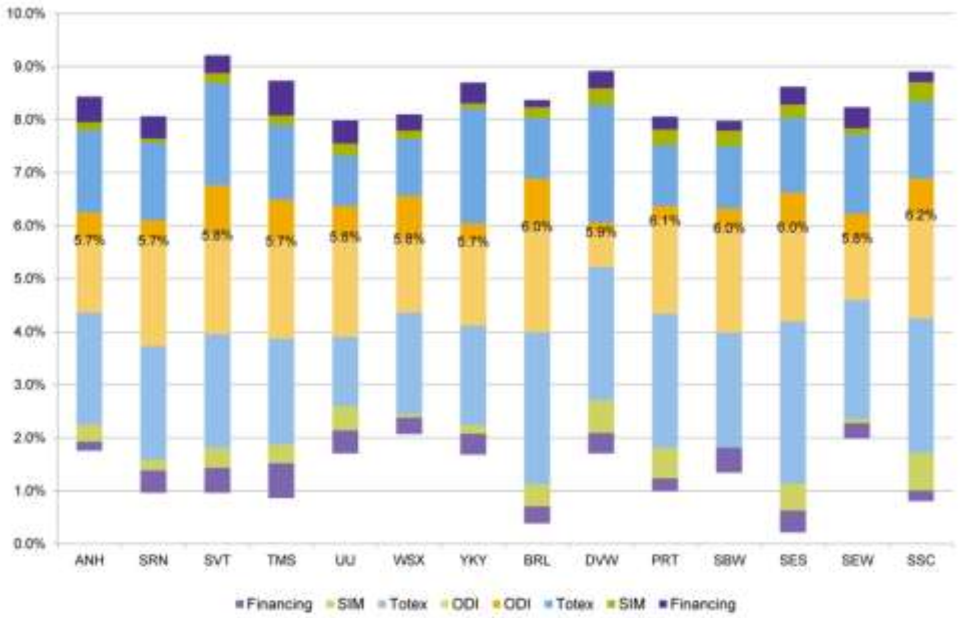
## Assessing the level of overall returns

For this review, we have changed the way we incentivise companies to outperform. We have designed the incentives to ensure that the interests of investors are better aligned with the interests of customers through providing incentives to outperform. We measure the scope for under and over-performance using the **RoRE**, which sets out the impact of risks on the company business plan.

Figure 5 sets out the RoRE range from each company's plan, updated to include an ODI performance range consistent with our interventions on performance commitments and ODIs. Our interventions affect the level of penalties and rewards and the design of caps and collars for company ODIs. The RoRE ranges are a useful tool for stakeholders to understand the impact of our interventions.

As companies respond to our interventions and amend their proposals ahead of final determinations in December 2014 we expect the RoRE range to change. We would expect each company to set out the impact of any changes in their proposals.

**Figure 5 RoRE range for water and wastewater companies compared with revised business plans**




## Our approach to uncertainty mechanisms

We consider that good risk sharing mechanisms provide companies with incentives to reduce costs and provide better services.

Companies have access to a range of uncertainty mechanisms designed to address risk, including, among other things:

- the periodic price control review;
- totex cost sharing incentives;
- indexation of allowed wholesale revenues and the (RCV) with the RPI; and
- the interim determination (IDoK) and substantial effects provisions in companies' licences.

All of these measures can effectively reduce companies' exposure to the unexpected variations in costs and/or revenues by allowing them to pass some of the unexpected variation on to customers through changes in bills.

For PR14, companies were able to propose their own uncertainty mechanisms in the business plans.

In our risk and reward guidance we said that we had identified the need for an **uncertainty mechanism** to deal with future costs associated with changes to water service business rates where we have included a mechanism with a sharing rate of 75:25 for all companies.

In their plans most companies set out proposals for uncertainty mechanism in this area as well as other suggested mechanisms (in areas such as the introduction of competition). We assessed each proposal by considering whether or not:

- the issue was likely to be **material**;
- the company management could **control** its impact;
- its circumstances were **comparable** with other companies; and
- **customers' interests would be protected**.

Our assessment did not identify any additional uncertainty mechanisms (with a financial implication) that satisfied these criteria against our high evidential bar.

# Proposals on customer bills

The draft determinations, if implemented, will drive substantial improvements to both the service customers receive directly and for the environment. But customers need to have the trust and confidence that companies are delivering these improvements efficiently, providing value for money. At the heart of this is the relationship between companies and their customers. This is a relationship that companies must own, and in line with this, it is for companies to decide how they set the charges that will flow through into customer bills in line with our final determination and their duties and obligations.

In their business plans, companies had to demonstrate that the plans were affordable for customers and reflected customer views on what they were willing to pay. They also needed to show that their plans were balancing the needs of both current and future customers.

Each company's plan set out its view of the implication for bill profiles (that is the rate of change in the bill over the 2015-20 period) of its plan. Our draft determinations imply a bill profile that may be different from company plan bill profiles. This is because many of the challenges we made to company proposals directly affected the revenue companies are allowed under the price controls. To the extent that this is higher or lower than the company plan, it means implied customers' bills will be different.

The draft price proposals for all 18 companies, if implemented, would result in average bills for water and wastewater customers in 2015-20 that are 5% lower than in 2010-15 in real terms.

For eleven of the companies receiving draft determinations today, figure 6 shows the difference between 2010-15 average bills and 2015-20 average bills based on our draft determinations.

Figure 7 shows the impact of our interventions on customer bills. It compares the difference between 2010-15 average bills and what 2015-20 average bills would be both under company plans and under our draft determinations.

Tables 3 and 4 set out the level of the bills during 2015-20.

These charts and tables exclude bills for the three companies with material gaps between our view and the company's view of wholesale cost (Bristol Water, Thames Water Tideway Tunnel and United Utilities). This is because we expect these companies to provide further evidence in response to our draft determinations, which makes it difficult to give a good indication of bills at this time.

All these figures remain indicative. 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. It is also important to recognise that:

- our draft determinations are not final decisions; where stakeholder representations support and evidence a change in approach this could affect the level and profile of bills; and
- 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 our final determinations.

**Figure 6 Comparison of average bill across 2010-15 to 2015-20 draft determination**

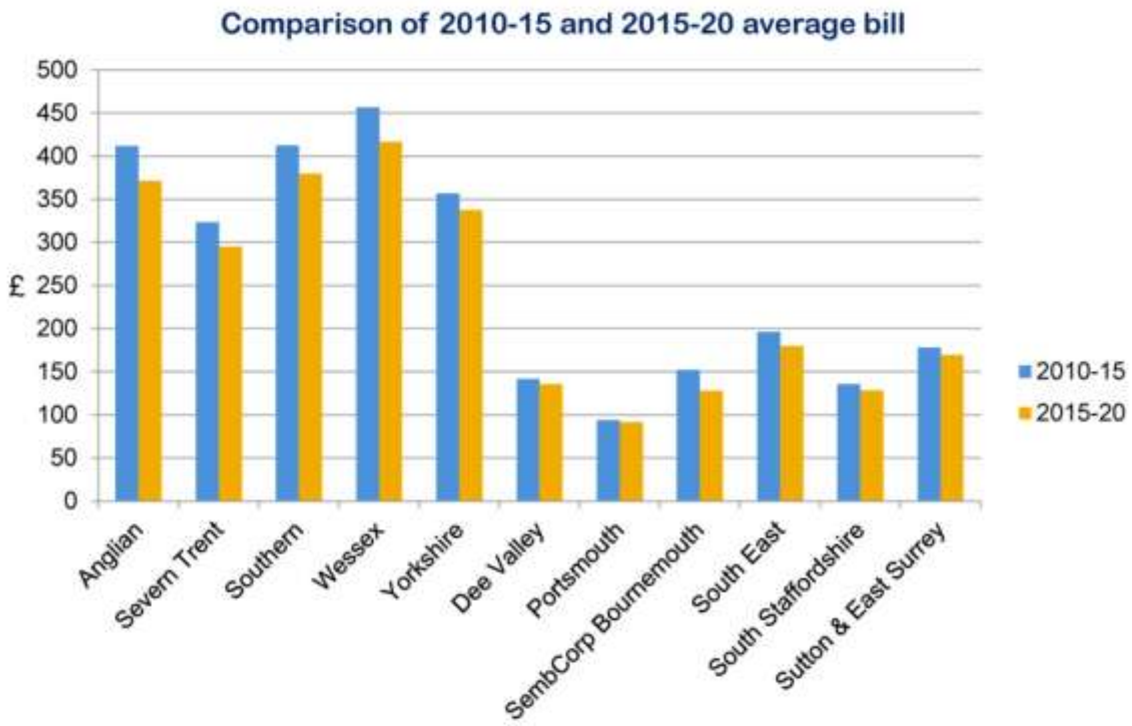


**Figure 7  Comparison of the average bill across 2010-15 to 2015-20 company proposed average and draft determination bills**

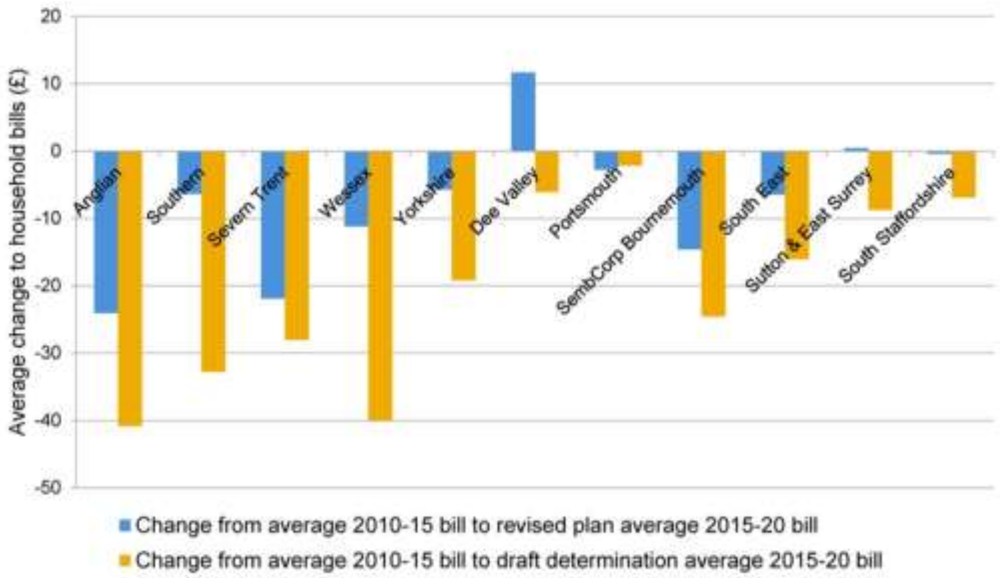



**Table 3  Average annual combined bill for water and sewerage companies (£)**

| | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---|---|---|---|---|---|---|
| Anglian | 408 | 380 | 375 | 370 | 368 | 363 |
| Severn Trent | 315 | 298 | 294 | 294 | 293 | 297 |
| Southern | 413 | 381 | 381 | 379 | 378 | 378 |
| Wessex | 459 | 417 | 417 | 417 | 416 | 416 |
| Yorkshire | 353 | 338 | 338 | 338 | 337 | 336 |

**Table 4  Average annual water bill for water only companies (£)**

| | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---|---|---|---|---|---|---|
| Dee Valley | 144 | 136 | 136 | 136 | 136 | 136 |
| Portsmouth | 92 | 92 | 92 | 92 | 92 | 92 |
| Sembcorp Bournemouth | 145 | 130 | 130 | 129 | 126 | 125 |
| South East | 190 | 181 | 181 | 180 | 179 | 179 |
| South Staffordshire | 133 | 130 | 129 | 128 | 128 | 128 |
| Sutton & East Surrey | 176 | 180 | 173 | 169 | 165 | 160 |

# What happens next

There is a five-week consultation process allowing all stakeholders to submit their views on our draft determinations. **We invite comments by 10am 3 October 2014**. We will give all representations we receive due care and attention.

In making their representations, companies:

- should consider carefully what their representations mean for customers and the environment now and in the future, explaining how they align with their customer priorities and affordability of overall bills; and
- ensure that they include in their representations all the specific requirements for further work (including engagement with CCGs) set out in their company-specific document, IN 14/14: '2014 price review – non-household customer engagement ahead of draft determination representations' the and other specific correspondence[5].

When we make our final determinations in December 2014, we will take the representations and any additional evidence we receive into account. We have already said that we expect to look again at the cost of capital as part of our final determinations, to take account of the most up-to-date evidence. We will continue to challenge companies to deliver in customers best interests and while ensuring that efficient companies continue to be able to finance their functions.

It is therefore possible, and likely, that some final determinations will be different from draft determinations. Where this is the case, we will set out the reasons for the changes.

We welcome comments on our draft determinations from all stakeholders. To help stakeholders to better understand our approach, alongside this overview we have also published:

- a number of technical appendices that summarise the general approach applied to all companies for draft determinations. They cover key aspects across all price controls; and

[5] 'Letter from Sonia Brown to a number of water companies – PR14 June business plan: Concerns regarding quality of data and assurance'.

- company-specific appendices, which set out our draft determinations for each individual company.

We will publish all of the representations we receive. Stakeholders should highlight the confidential aspects of their representation, and set out the reasons why they should be kept confidential.

Representations on the draft determinations can be emailed to price.review@ofwat.gsi.gov.uk or posted to:

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA.

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