August 2014

Setting price controls for 2015-20

Draft price control determination notice: company-specific appendix – Dee Valley Water

OFWAT

Contents

Overview

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

Dee Valley Water made changes to its plan following the outcome of the risk-based review. We do however continue to have concerns surrounding its wholesale water costs, risk and reward package, and proposals relating to household and non-household retail. In addition we are making further interventions in the company's business plan designed to safeguard customers' interests around outcomes and the associated delivery incentives which are common to all companies.

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

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

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

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

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

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

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

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

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

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

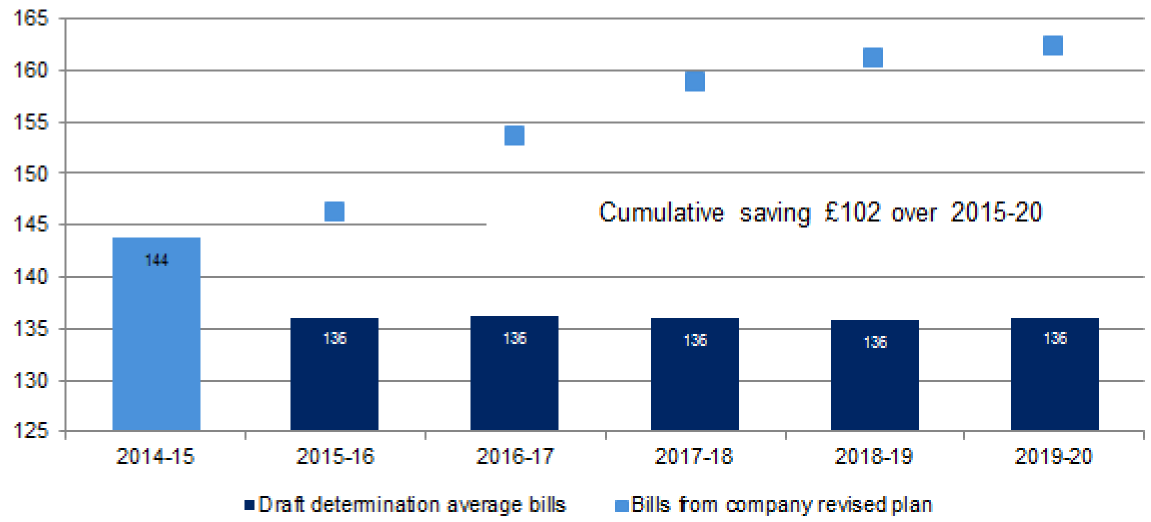
Annexes 1 to 4 form part of the draft price control determination.

A1 Draft determination for Dee Valley Water – at a glance

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

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

Average household bill (£)



Note:

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

Outcomes

Wholesale water
Provide excellent water quality
Provide reliable and high quality customer service
Minimise the environmental impact
Provide a value for money service
Retail
Provide reliable and high quality customer service

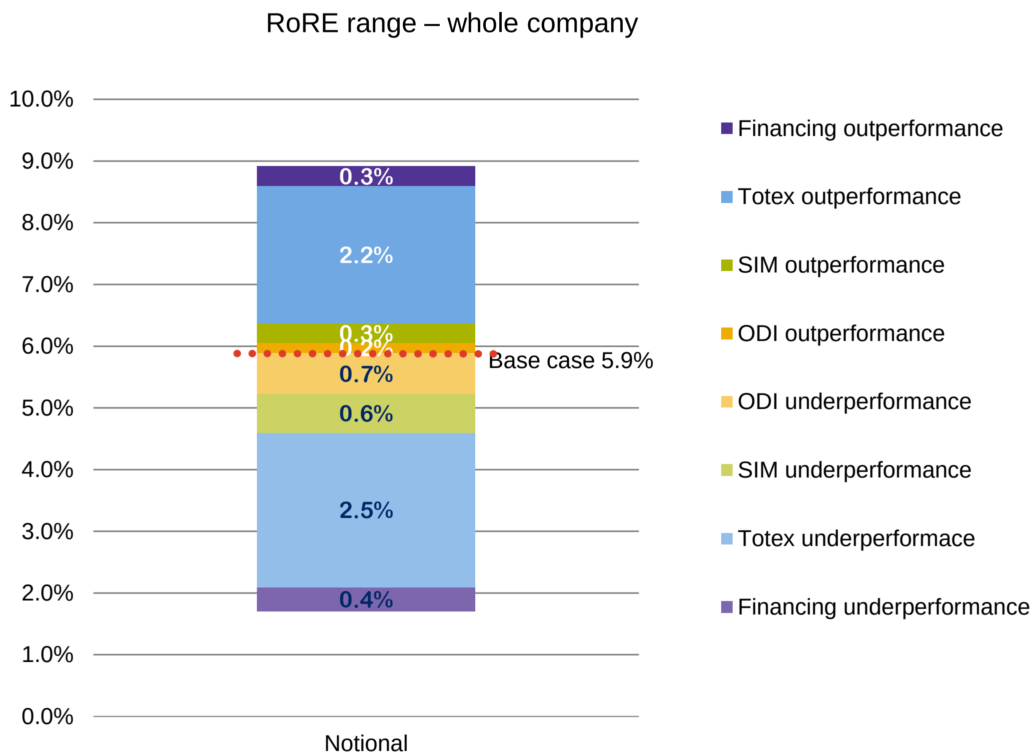
Allowed costs/expenditure[1]

Wholesale	Water	
Totex – 2015-20 total (£m)	93.8	
Allowed weighted average cost of capital (%)	3.70%	
Allowed wholesale revenue in 2015-20 (£m)	100.0	
Retail	**Household**	**Non-household**
Cost allowance – 2015-20 total (£m)	12.7	
Margin (%)	1.00%	1.35%
Retail allowed revenue (£m)	13.6	2.0
Average bill per household customer – retail component only (£)	23	

Note:

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

RoRE ranges – appointee



Ofwat's calculation of notional financeability ratios

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Cash interest cover	3.25
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.50
Funds from operations/debt	10.88%

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Retained cash flow/debt	8.48%
Gearing	67.65%
Dividend cover (profit after tax/dividends paid)	1.35
Regulatory equity/regulated earnings for the regulated company	16.03
RCV/EBITDA	9.28

Summary of interventions

General

We have identified systemic issues with the quality of data and assurance throughout Dee Valley Water's revised business plan. We are therefore requiring Dee Valley Water to provide third party assurance on any representations it makes on this draft determination.

Outcomes

- **Cap:** We have imposed an overall cap and collar on outcome delivery incentives of +/- 2% of RoRE.
- **Horizontal check**: We have made some performance level targets more stretching and changed the reward and penalty deadbands.
- **Bottom-up analysis:** We have changed the performance level, incentive rate, deadbands and caps and collars for some performance commitments (PCs) or outcome delivery incentives (ODIs).
- We have added a new performance commitment and outcome delivery incentive in relation to the rebuilding of its treatment works at Legacy.

Wholesale water costs

- The company proposed wholesale water totex of £103 million in its plan, which is £11 million above our draft determination threshold of £92 million.
- We have rejected some of the company's adjustments, or only partially allowed them. We also made some adjustments to reflect our modelling approach

Retail

- We have rejected the company's proposed adjustments for input price pressure and new costs and made other minor adjustments, including to the price base of its costs.
- We have significantly adjusted the company's default tariffs to ensure there are separate tariffs for contestable and non-contestable customers (non-household).
- We have added a non-household service incentive mechanism (SIM) to the companies ODIs. The performance commitments will be finalised in the companies' final determination.

Reconciling 2010-15 performance

- We have made minor adjustments which reduce the company's proposed revenue adjustments by £0.015m and its regulatory capital value adjustments by £0.002m.

Risk and reward

- We have rejected the company's proposed company specific uplift to the wholesale weighted average cost of capital (WACC) and replaced its retail net margins for households and non-households.
- We have made a minor adjustment to the proposed sharing rate for the water business rate uncertainty mechanism and rejected the other proposed mechanisms.

Financeability and affordability

- In the absence of customer preferences for bill profiles, we have reprofiled bills so that there is a reduction in the first year with flat bills for the remainder of the period.

A1.1 Assurance

We wrote to Dee Valley Water in August expressing concerns about systemic issues we had identified with the quality of data and assurance provided as part of its June revised business plan. Our concerns about the quality of the information, and the materiality of changes made after our queries, increased as we progressed our assessment.

To ensure that our final determination for the company is based on high quality information and delivers the right outcome for customers we are therefore requiring Dee Valley Water to provide third party assurance on any representations it makes on this draft determination. We will also require the company's Board to provide additional assurance as part of any representations. This applies in particular, but it is not limited, to the following areas.

- **Business plan tables.** We require the company's third party assurers to confirm that any resubmitted business plan tables are fit and proper and consistent with our guidance.
- **Wholesale costs.** We require the company to provide third party assurance alongside representations on costs that it considers are specific to it as a company or are not covered by our models, including on the robustness and efficiency of those costs.
- **Cost allocation.** We require the company to provide copies of the external assurance reports covering the June revised business plan tables R3 and R4, updated for any changes made between its June plan and October submissions.
- **Financeability.** We require the company to provide Board and additional third party assurance on financeability in response to the draft determinations given the significant issues we identified with the financial data provided by the company during our review of its business plan. As part of this the company should also provide Board assurance on the company's ability to deal with the risks that it faces.

Consistent with a proportionate and risk based approach to regulation, we may put in place more onerous regulatory reporting requirements and/or a more onerous assurance regime from 2015-16 if concerns over data quality and assurance remain when we are making our final determination.

In the assurance technical appendix, we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015-2020 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself.

A2. Wholesale water

A2.1 Company outcomes, performance commitments and delivery incentives

A2.1.1 Outcomes, performance commitments and incentives

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

We summarise the outcomes, performance commitments and outcome delivery incentives for the wholesale water control for Dee Valley Water in Table A2.1 below.

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

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

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

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Provide excellent water quality	Discoloured water contacts	Financial – reward and penalty	**Horizontal check:** Adjust the performance commitment level and adjust the deadbands, cap and collar accordingly
	Mean zonal compliance	Financial – penalty only	**Horizontal check:** Increase the performance

Company proposal			Intervention
Outcome	**Performance commitment**	**Incentive type**	
			commitment level and adjust the deadband.
	Legacy Treatment Works	Financial – penalty only	**Bottom-up analysis:** We have introduced an additional ODI and PC.
Provide reliable and high quality customer service	Average duration of interruption	Reputational incentive	**Horizontal check:** Change to reward and penalty. Clarify performance commitment. Adjust the performance commitment level and introduce deadbands, cap and collar.
	Sustainable economic level of leakage target	Financial – reward and penalty	**Bottom-up analysis:** Increase the penalty rate.
	Security of supply index	Reputational incentive	No intervention
	Number of bursts	Financial – reward and penalty	**Bottom-up analysis:** Adjust the performance commitment level and adjust the deadbands, caps and collars accordingly.
Minimise the environmental impact	Gross operational greenhouse gas emissions	Reputational incentive	No intervention

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Provide a value-for-money service	Customers perception based on market research	Reputational incentive	**Bottom-up analysis:** Clarify performance commitment.

A2.1.2 Outcome delivery and reporting

In the assurance technical appendix, we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015-2020 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself.

We are satisfied with the company's proposals for self-reporting. But consistent with the commentary in our assurance technical appendix, we will need to consider the categorisation of the company for assurance purposes at the final determination. As noted in section A1.1 we are seeking additional assurance of its representations on its draft determination because of concerns around the quality of information that has been provided.

Dee Valley Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach is summarised in annex 4.

A2.2 Calculating the wholesale water price control

A2.2.1 Calculating allowed wholesale water expenditure

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

In Dee Valley Water's revised plan the company proposed wholesale water totex of £103m over 2015-2020 (which is £1m more than its December plan). We calculated the draft determination threshold at £92m, giving rise to a difference of £11m or 12%. We did consider making a further £14m in adjustments to our threshold (net of implicit allowances), however the company did not provide sufficient evidence to support these claims. We also note that the company made representations to our cost models following the publication of these in April. The representations made and our response is summarised in wholesale water and wastewater technical appendix.

It is also important to bear in mind that the actual gap faced by the company is smaller than what would be implied when looking at the totex gap. This is because the use of menus and our approach to setting baselines reduces the difference faced by the company. In particular, the difference between the company's plan and the amount that it would ultimately recover from customers is only 5.6%.

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

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Draft determination cost threshold						91.9
Costs excluded from menu						1.6
Menu cost baseline[1]	19.1	22.7	20.6	14.0	13.8	90.3
Company's view of menu costs[2]						101.4
Implied menu choice						112.3
Allowed expenditure from menu	19.7	23.4	21.3	14.5	14.3	93.1
Costs excluded from menu	0.3	0.3	0.3	0.3	0.3	1.6
Total allowed expenditure[3]	20.0	23.7	21.6	14.8	14.6	94.6
Less pension deficit repair allowance	0.2	0.2	0.2	0.2	0.2	0.9
Totex for input to PAYG	19.8	23.5	21.4	14.6	14.4	93.8

Notes:

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

A2.2.2 Calculation of Revenues: pay as you go (PAYG) and regulatory capital value (RCV)-run off

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

Table A2.3 Dee Valley Water wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£m)	19.8	23.5	21.4	14.6	14.4	93.8
PAYG %	50.2%	44.5%	49.6%	74.0%	76.9%	59.0%
Resulting PAYG (£m)	10.0	10.5	10.6	10.8	11.1	52.9

Table A2.4 shows the RCV run-off amounts included within the wholesale water charge. This reflects a run-off rate of 6.1% for the RCV as at 31 March 2015 and 29 years for the totex additions to the RCV over 2015-20.

Table A2.4 Dee Valley Water wholesale water RCV run-off (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Run-off of 2015 RCV	4.1	3.9	3.6	3.4	3.2	18.2
RCV run-off of totex additions	0.2	0.6	1.0	1.2	1.4	4.3
Total RCV run-off	4.3	4.4	4.6	4.6	4.6	22.5

A2.2.3 Return on the RCV

The company has asked for a company specific uplift of 120bp to the wholesale WACC of 3.70% set out in the risk and reward guidance. We have considered whether it would be appropriate to allow for this uplift based on the approach we set out in our risk and reward guidance:

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

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

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

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

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

We have therefore intervened and used a wholesale water cost of capital of 3.70% in this draft determination. This results in a return on capital of £15 million over 2015-20.

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

Table A2.5 Dee Valley Water wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	68.4
Land sales	-0.1
Adjustment for actual expenditure 2009-10	2.1

	2015-16
Adjustment for actual expenditure 2010-15[1]	-3.2
Net adjustment from logging up, logging down and shortfalls	0.4
Other adjustments	0.0
Opening RCV 1 April 2015	67.6

Note:

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

Table A2.6 Dee Valley Water wholesale water return on RCV (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	67.6	73.1	81.8	87.9	87.1
RCV additions (from totex)	9.9	13.1	10.8	3.8	3.3
Less RCV run-off	4.3	4.4	4.6	4.6	4.6
Closing RCV	73.1	81.8	87.9	87.1	85.9
Average RCV (year average)	70.3	77.4	84.8	87.5	86.5
Return on capital	2.6	2.9	3.1	3.2	3.2

A2.2.4 Reconciling 2010-15 performance

Our approach to reconciling 2010-15 performance is set out in the wholesale water and wastewater technical appendix.

As a result of our interventions, we have made overall changes to proposed 2010-15 adjustments for the opening RCV and allowed revenues for the wholesale water service. Our interventions have reduced 2010-15 revenue adjustments for wholesale water by £0.015m to £3.9m. We summarise these interventions in Table A2.7 below, and quantify the resulting adjustments within this draft determination. The impact on the opening RCV of 2010-15 adjustments is shown in Table A2.5 and we discuss our interventions in this area further in annex 3.

Table A2.7 Dee Valley Water wholesale water revenue adjustments to reflect 2010-15 performance (£ million)

Area	Intervention	Why we did it	Total 2015-20
Service incentive mechanism (SIM)	SIM performance penalty has increased.	Our adjustment reflects updated industry performance and the correction for a sampling survey error in 2013-14. The company had also sought to correct for this error but its assumptions of the correction were greater than ours. Our intervention corrects the error to the scale of difference related to just the samples that have failed and this aligns with the national view of performance.	-0.1
Revenue correction mechanism (RCM)	We have intervened in the following areas. • Forecast 2014-15 tariff basket revenue. • FD09 assumptions. • Number of households billed. • Net revenue movement out of tariff basket in 2009-10. • Number of non-households billed.	We have concerns about the company's forecast 2014-15 tariff basket revenues, FD09 assumptions and data inconsistencies.	5.0

Area	Intervention	Why we did it	Total 2015-20
Opex incentive allowance (OIA)	There are no interventions in this area.	n/a	0.0
Capital expenditure incentive scheme (CIS)	There are no interventions in this area other than we have included our view of the applicable change protocol amounts.	n/a	-1.0
Other adjustments	There are no interventions in this area.	n/a	0.0
Total	n/a	n/a	3.9

A2.2.5 Calculation of allowed revenue

We set out the calculation of the allowed revenue for Dee Valley Water's wholesale water control in Table A2.8.

Overall, we consider that the company's wholesale water revenue allowance should be £19.7 million in 2015-16, increasing by 3.4% to £20.3 million in 2019-20.

Table A2.8 Dee Valley Water wholesale water allowed revenue (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Totex	19.8	23.5	21.4	14.6	14.4	93.8
PAYG ratio	50.20%	44.50%	49.60%	74.00%	76.90%	-
Totex additions to the RCV	9.9	13.1	10.8	3.8	3.3	40.8
RCV (year average)	70.3	77.4	84.8	87.5	86.5	-
Wholesale allowed revenue build up:						
PAYG[1]	10.1	10.7	10.8	11.0	11.3	53.8
Return on	2.6	2.9	3.1	3.2	3.2	15.0

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
capital						
RCV run-off	4.3	4.4	4.6	4.6	4.6	22.5
Tax[2]	0.1	0.2	0.2	0.3	0.4	1.3
Income from other sources	-0.1	-0.1	-0.1	-0.1	-0.1	-0.6
Reconciling 2010-15 performance	0.8	0.8	0.8	0.8	0.8	3.9
Ex ante additional menu income	-0.3	-0.4	-0.3	-0.2	-0.2	-1.5
Wholesale allowed revenue adjustments:						
Profiling adjustments[3]	1.0	0.3	-0.2	-0.6	-0.7	-0.3
Capital contributions from connection charges and revenue from infrastructure charges	1.2	1.1	1.1	1.1	1.1	5.7
Final allowed revenues	**19.7**	**19.8**	**20.0**	**20.2**	**20.3**	**100.0**

Notes:

1. PAYG includes the PAYG calculated from totex and the pension deficit repair allowance.
2. Including tax on adjustments for reconciling 2010-15 performance and ex-ante additional menu income.
3. Our bill profiling adjustments are discussed in section A5.4.

A2.3 Uncertainty mechanisms

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

Table A2.9 Dee Valley Water proposals for wholesale water uncertainty mechanisms

Dee Valley Water proposals	Our assessment
Water business rates notified item with 80:20 customer company sharing rate	We consider the materiality, comparability and control over risk criteria for business rates are met. We have included a 75%:25% uncertainty mechanism for all companies consistent with our prior guidance and earlier draft determinations. No compelling evidence has been submitted that would convince us to change the sharing rate. The specific text of this Notified Item and the rationale for its inclusion in the draft determination is set out in the risk and reward technical appendix.
Traffic Management Act	We do not accept the need for an uncertainty mechanism for the following reasons: **Materiality: Fail.** The downside scenario presented by Dee Valley Water for costs incurred under the Traffic Management Act (TMA) represents a combined variance of about 0.75% of wholesale totex over the whole of 2015-20, which is too small to be material. **Controllability: Fail.** Dee Valley Water has some control over the amount it spends on TMA fees, should such a scheme be introduced in the Welsh part of its service area. **Comparability with other companies: Fail.** This risk is well understood and common to many companies. Dee Valley Water has not provided adequate justification to demonstrate why it requires specific protection from these risks when other companies do not. **Customer protection: Fail.** We consider that it would be inappropriate for Dee Valley Water customers to bear 100% of this risk when customers of all other companies bear only a portion of the risk with their respective companies through the totex menu.
Supply pipes transfer	We do not accept the need for an uncertainty mechanism for the following reasons: **Materiality: Fail.** The downside scenario presented by Dee Valley Water for costs incurred due to a transfer of private supply pipes represents a combined variance of about 0.5%-1% of wholesale totex over the whole of 2015-20, which is too small to be material. **Controllability: Fail.** Dee Valley Water has substantial control over the amount it spends due to the transfer of private supply pipes, should this be enacted. **Comparability with other companies: Fail.** This risk is well understood and common to all companies. Dee Valley Water has not

Dee Valley Water proposals	Our assessment
	provided adequate justification to demonstrate why it requires specific protection from these risks when other companies have not required protection. **Customer protection: Fail.** We consider that it would be inappropriate for Dee Valley Water customers to bear 100% of this risk when customers of all other companies bear only a portion of the risk with their respective companies through the totex menu.
Introduction of competition	We do not accept the need for an uncertainty mechanism for the following reasons: **Materiality: Pass.** The downside scenario presented by Dee Valley Water for costs incurred due to the introduction of competition in Wales or in the English part of Dee Valley Water's supply area represents a combined variance of about 10% of wholesale totex over the whole of 2015-20, suggesting that this is a material risk. **Controllability: Fail.** Dee Valley Water has substantial control over the amount it spends if competition were introduced in all or parts of its supply area, should this be enacted. **Comparability with other companies: Fail.** This risk is well understood and common to both Welsh companies. Dee Valley Water has not provided adequate justification to demonstrate why it requires specific protection from these risks when Dŵr Cymru has not. **Customer protection: Fail.** We consider that it would be inappropriate for Dee Valley Water customers to bear 100% of this risk when customers of all other companies – and in particular Dŵr Cymru – bear only a portion of the risk with their respective companies through the totex menu.

A3. Household retail

A3.1 Company outcomes, performance commitments and delivery incentives

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

We summarise the outcomes, performance commitments and outcome delivery incentives for the household retail control for Dee Valley Water in Table A3.1 below.

For some performance commitments and incentives types, we have intervened to change the underlying performance level or incentives. These interventions are listed in Table A3.1 below. Full detail of the wholesale water outcomes, performance commitments and incentives is provided in annex 4.

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

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Provide reliable and high quality customer service	Per capita consumption and water efficiency	Reputational incentive	No intervention
	Service incentive mechanism	Financial – reward and penalty	No intervention

A3.1.1 Outcome delivery and reporting

In the assurance technical appendix, we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015-2020 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself.

We are satisfied with the company's proposals for self-reporting. But consistent with the commentary in our assurance technical appendix, we will need to consider the categorisation of the company for assurance purposes at the final determination. As noted in section A1.1 we are seeking additional assurance of its representations on its draft determination because of concerns around the quality of information that has been provided.

Dee Valley Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach is summarised in annex 4.

A3.2 Costs

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

A3.2.1 Allocation of costs

In Table A3.2 below, we summarise our assessment of Dee Valley Water's cost allocation methodology.

Table A3.2 Our assessment of Dee Valley Water's cost allocation methodology

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

We will use the company's cost allocations between retail and wholesale and between household and non-household to set our draft determination. However, we noted the following issues with respect to the company's cost allocation.

- The company has not allocated IT costs, facilities and local authority rates between retail and wholesale in accordance with our guidance.
- The company has not allocated billing, payment handling, remittance and cash handling, non-network customer enquiries and complaints, debt management and disconnection and reconnection costs between household and non-household in accordance with our guidance.
- The company has not stated how it has allocated motor vehicle costs, insurance costs and cumulo rates between retail and wholesale and between household and non-household.

We note that the company did not provide a reconciliation between their December and June submissions of tables R3 and R4, as required by our guidance. This means that we do not have any comfort over the completeness and accuracy of the adjustments made between December and June.

We also note that while the company states that it has obtained external assurance over the values in R3 and R4 from Frontier Economics and over its business plan cost allocations from Deloitte, it has not provided us with a copy of the assurance reports. Therefore, we cannot place any reliance on this assurance.

In order to address the issues that we have identified, we expect the company to submit the following information to us with its draft determination representations, by **3 October 2014** at the latest.

- Revised tables R3 and R4 with the allocations noted above corrected and, where necessary, clarified.
- The detailed cost allocation tables for 2013-14 for retail/wholesale and household/non-household to support the revised figures in lines 1 of R3 and R4.
- A full reconciliation between lines 1 of R3 and R4 in the company's October 2014 and December 2013 submissions.
- Copies of the external assurance reports from Frontier Economics and Deloitte covering the June submission of tables R3 and R4, updated for any changes made between the June and October submissions.

As noted in section A1.1 we are seeking additional assurance of its representations on its draft determination because of concerns around the quality of information that has been provided.

While reviewing the company's cost allocations, we also noted that the company had submitted tables R3 and R4 in 2013-14 outturn prices. This is not in line with our guidance which required these tables to be prepared in 2012-13 base year prices. We have amended our models to deflate the company's household and non-household costs to 2012-13 base year prices.

A3.2.2 Adjustments

In Table A3.3 below, we outline Dee Valley Water's proposed average cost to serve (ACTS) adjustments and our assessment of these proposals. The adjustments proposed by Dee Valley Water and Ofwat are quantified in Table A3.4.

Table A3.3 Dee Valley Water proposals for ACTS adjustments

		Adjustment assessment criteria			
Adjustment	**Value (£m over 2015-20)**	**Materiality**	**Beyond efficient management control**	**Impact company in materially different way**	**Value of adjustment appropriate**
Input price pressure	1.6	Pass	Fail	Efficiency benchmarking evidence: Fail Upper quartile: Fail	Fail

Dee Valley Water proposed an adjustment for Input Price Pressure (IPP) of £1.6m over 2015-20.

We reject Dee Valley Water's proposal for an ACTS adjustment for input price pressure. Dee Valley Water does not show that these costs are outside of efficient management control or demonstrate that they are affected in a materially different way to other companies.

The value of the adjustment is material, at 9.1% of household retail operating expenditure plus depreciation over 2015-20.

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

The evidence provided on relative efficiency includes a comparison of wages between Dee Valley Water and regional pay rates, as well as wages at equivalently sized utilities in Northern Ireland. No benchmarking of efficiency is provided. We do not consider this to be sufficient evidence to demonstrate that Dee Valley Water is an efficient retailer compared to companies outside of the water industry.

Our assessment for ACTS suggests that Dee Valley Water are not upper quartile efficient for unmetered retail costs but are for metered costs. The household retail technical appendix explains how we assessed input price pressure claims in more detail.

Although we do not consider that an adjustment for input price pressure is appropriate for Dee Valley Water, for completeness we have assessed the evidence provided on the size of an adjustment. The evidence provided to support the size of the adjustment is insufficient. The adjustment is based on RPI with a 0.5% efficiency challenge. An appropriate basis for an input price pressure claim would include measures of inflation that relate to the specific cost pressures faced by water retailers – for example, call centre wage costs.

Table A3.4 Household retail adjustments (£ million, nominal prices)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Adjustments proposed in Dee Valley Water's business plan						
Input price pressure	0.204	0.269	0.332	0.388	0.437	1.630
Customer communications costs	0.051	0.051	0.050	0.050	0.050	0.251
New development costs	0.023	0.030	0.037	0.044	0.050	0.185
Social tariffs costs	0.051	0.044	0.067	0.064	0.064	0.291
Pension deficit repair costs	0.039	0.039	0.039	0.039	0.039	0.195
Adjustments included in business plan	**0.368**	**0.433**	**0.525**	**0.585**	**0.640**	**2.552**
Adjustments included in draft determination						
Input price pressure	0.000	0.000	0.000	0.000	0.000	0.000
Customer communications costs	Not included as adjustment – forms part of new cost					
New development costs	Not included as adjustment – forms part of new cost					
Social tariffs costs	Not included as adjustment – forms part of new cost					
Pension deficit repair costs	0.037	0.037	0.037	0.037	0.037	0.187
Adjustments included in draft determination	**0.037**	**0.037**	**0.037**	**0.037**	**0.037**	**0.187**

Note:

There will be no indexation for retail price controls.

A3.2.3 New costs

In Table A3.5 below, we outline Dee Valley Water's proposed 'new costs' and our assessment of these proposals. The new costs included in this draft determination are quantified in table A3.6.

Table A3.5 Dee Valley Water proposals for household retail new costs

	New costs assessment criteria				
Value (£mover 2015-20)	Materiality	Need	Options and CBA	Robustness of costs	Customer protection
1.0	Pass	Fail	Fail	Fail	Fail

We reject Dee Valley Water's proposed new costs. All new costs above the materiality threshold are excluded from the calculation of allowed revenues. The evidence base supporting new costs is considered to be neither sufficient nor convincing. The need for the new costs is not justified, the costs have not been shown to be the most cost beneficial means of meeting the need, the costs are not shown to be robust and customer protection is not discussed in relation to the new investments.

Dee Valley Water's new costs are material (5.7% of total household retail operating expenditure plus depreciation over 2015-20). These include costs in relation to new developments, introducing social tariffs, improving customer communications and investment in telephone, customer billing and accounting systems.

Part of 'new development costs' relates to metering of new customers and so we have reallocated this to the additional cost to serve metered customers.

A description of new costs is given, but no additional evidence has been provided on the need for the new costs.

No evidence has been provided on whether the proposed new costs provide the most cost beneficial solution. No options analysis or cost benefit analysis is provided.

Some additional breakdown of new opex is provided which demonstrates that the costs have been arrived at bottom-up. However, there is no evidence that these are robust estimates of efficient costs. There is no market testing to show that these are estimates of efficient costs. No evidence is provided to show that the costs are robust for new capex.

The SIM will provide some protection to customers for the impact of these costs on service levels, but an explicit link is not made from these costs to customer outcomes.

The evidence base is considered to be neither sufficient nor convincing and so we have rejected the new costs. The need for new costs is not justified, the costs have not been shown to be the most cost beneficial means of meeting the need, the costs are not shown to be robust and customer protection is not discussed in depth.

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

	Value
Modification made to 2013-14 CTS for ACTS calculation	0.57

Note:

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

A3.3 Calculating the allowed revenues

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

A3.3.1 Net margins

Table A3.7 below shows the household retail net margin over 2015-20.

Both in its original Business Plan submission in December 2013 and in its resubmission in June 2014, Dee Valley Water insisted that it – and indeed all water companies – should be allowed a household retail net margin of 1.5%. Since Dee Valley Water did not submit any new evidence on the retail margin in its June resubmission, we confirm our analysis as set out in the risk and reward guidance (where we considered Dee Valley Water's earlier evidence) and therefore do not accept Dee Valley Water's proposal that the overall household margin should be 1.5%.

In our engagement with Dee Valley Water it also stated that it should have a 1.5% household retail margin on the grounds that it is "the smallest water company in the sector and therefore has higher risk and financing and other costs compared to other companies in the water sector." However, it did not provide supporting evidence on why its arguments supporting an application for a company-specific adjustment to the WACC might apply equally to the retail margin. We therefore reject Dee Valley Water's request for a company-specific uplift to its household retail margin.

Table A3.7 Household retail net margins (%)

	2015-16	2016-17	2017-18	2018-19	2019-20
Proposed household retail net margin	1.50%	1.50%	1.50%	1.50%	1.50%
Allowed household retail net margin	1.00%	1.00%	1.00%	1.00%	1.00%

Table A3.8 below sets out the components of the allowed household retail revenue.

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

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Company cost to serve (£/customer)						
Unmetered single service customers	22.38					
Metered water only customers	25.24					
Industry average cost to serve (£/customer)						
Unmetered single service customers	20.73					
Metered water only customers	24.04					
Allowed cost to serve (£/customer)[1]						
Unmetered single service customers		20.11	19.85	19.46	19.15	19.23
Metered water only customers		22.96	22.72	22.34	22.03	22.13
Total allowed (£ million)						
Cost to serve (excluding net margin)		2.6	2.6	2.5	2.5	2.6
Forecast household wholesale charge (including forecast RPI[2])[3]		20.3	21.2	22.1	23.1	24.0
Household retail revenue		3	3	3	3	3

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
(including an allowance for the net margin)[4]						

Notes:

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

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

A3.4 Uncertainty mechanisms

We outline our approach to uncertainty mechanisms in the risk and reward technical appendix. In Table A3.9 below, we set out Dee Valley Water's proposed household retail uncertainty mechanisms and our assessment of these proposals.

Table A3.9 Dee Valley Water proposals for household retail uncertainty mechanisms

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

A4. Non-household retail

In the non-household retail technical appendix, we outline our overall approach to the non-household retail price control. Further information regarding our observations on companies' proposals for their non-household retail price controls is set out in Information Note 14 – 2014 price review – non-household customer engagement ahead of draft determination representations.

In this chapter, we provide details of Dee Valley Water's non-household retail draft determination.

A4.1 Indicative non-household retail total revenue

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

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

	2015-16	2016-17	2017-18	2018-19	2019-20
Indicative non-household retail total revenue price control including net margins	0.4	0.4	0.4	0.4	0.4

Note:

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

A4.2 Net margins

The company did not follow our risk and reward guidance. In its business plan it proposed a net margin of 1.5%. The company did not provide an explanation as to how this figure was derived, but stated that it had used the same figure as its household proposals.

However, the data tables provided included a net margin of 3.1% on aggregate over the control period, with the figure varying by year and by customer type. We queried this. The company resubmitted its tables twice, with the first submission including a net margin of 1.4% on aggregate over the control period, with the figure varying by year and by customer type and the second submission including a net margin of 1.3% on aggregate over the control period, with the figure varying by year and by customer type. In its response the company referred us to its initial business plan for its "reasoning for a non-household retail margin of 1.5%".

The company's initial business plan submission did not provide details on how the net margin was derived, beyond stating that it is "half the level suggested by the Oxera report" and was the same as its household retail net margin. The company provided the Oxera report, but the report did not include a rationale for halving the mid-point of its stated range.

Given the lack of evidence supporting the company's proposed net margins, we have over-written its proposals in line with our risk and reward guidance – that is, net margins of 1.0% for all non-contestable customer types, and 2.5% for contestable customers.

A4.3 Cost proposals

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

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

The table requirements stipulated the use of 2012-13 prices. The company did not deflate its costs; therefore we have deflated its submission from 2013-14 prices to 2012-13 prices.

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

This resulted in the company's proposals being adjusted from £0.380 million over the control period, to £0.030 million.

The company's proposals included a downward adjustment of £0.330 million over the control period. The company identified this in its business plan as "deduct retail inflation". The adjustment did not appear to be a price base adjustment, as it was deducting an increasing value each year from its base costs. We queried this. The company stated that this was "due to a modelling error". Given that the adjustment was clearly labelled "deduct retail inflation" in the company's business plan with the amount deducted increasing each year, we consider this to be a likely explanation. We therefore removed the £0.330 million downward adjustment (£0.321 million having adjusted for the price base).

In a separate query response, the company also stated that it had intended to include an allowance for input price pressures of £0.278 million, and that this had been omitted in error. This figure was not accompanied by supporting evidence in the non-household retail control. No evidence was provided as to why the net margin was insufficient for covering input price risks. While the company did provide evidence to explain an input price pressure allowance in the household retail control, this evidence did not pass our criteria on the quality of supporting evidence, and was deemed insufficient to grant an ACTS adjustment. Consequently, we have not added an input price pressure element to the company's non-household proposals.

In total, this resulted in the company's proposed costs being adjusted from £2.011 million over the control period to £1.937 million (pre-efficiency).

In the company's business plan submission, the company did not provide separate cost allocations for customers above and below the 50 Ml threshold, as we stated was required in 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs'. We set this as a requirement as customers above the threshold in companies operating wholly or mainly in Wales are able to choose their supplier, while customers below that threshold are unable to do so. Consequently, the different customer types may require different net margins, with the customer types below the threshold receiving additional protection through the application of an efficiency challenge.

We therefore requested, through a query, for the company to separate its data, which it did. However, through subsequent correspondence, the company confirmed that one of its other proposed customer types also included a mixture of customers above and below the 50 Ml threshold.

Due to the late arrival of this information, we were unable to request the company to resubmit its data tables in time for the draft determinations. Consequently, we proportioned costs between two of its tariff types based on the contestable/non-contestable customer numbers the company provided in its email. We recognise that this is an assumption, and may contain a degree of inaccuracy.

We therefore request for the company to provide us with a more accurate forecast (see below) as part of its representations.

In a query response, the company stated that it had allocated costs in line with current revenue levels – that is, it had not undertaken a cost-reflective allocation exercise. An under-allocation of costs to contestable customers would result in non-contestable customers subsidising contestable customers. An over-allocation of costs to contestable customers could result in the company appearing unjustifiably ‘efficient’ through our comparative efficiency assessment. We therefore intervened with the company’s cost allocations between customer types.

To set the allocations for contestable customers we calculated an average cost per customer of companies with similar tariff structures. We then allocated the residual costs in line with the company’s cost allocations for its non-contestable customers. We recognise that this is an assumption, and may contain a degree of inaccuracy. **We therefore request for the company to provide us with a more accurate forecast as part of its representations. However, due to the numerous data issues outlined above, we would expect the company to provide a significantly more robust assurance process for any further data provided.**

A4.4 Efficiency challenge

In our final methodology statement, we confirmed that we would set an up-front non-household efficiency challenge for companies operating wholly or mainly in Wales, based on comparisons with equivalent English default tariffs.

In setting the benchmark for the company, we have compared costs across the industry for two different tariff types; water unmeasured, and water measured (<50 Ml). We have weighted the implied challenge from each tariff type by the number of customers the company has on each tariff type.

This gave Dee Valley Water an implied efficiency challenge of 24% from 2013-14. As the company is proposing (after all of the above adjustments) a 4% increase in costs from 2013-14 levels; we have chosen to apply the efficiency challenge, as this delivers greater value to customers over the period.

Like the household control, we are applying a glide-path approach to efficiencies, with the efficient level of spend only needing to be fully reached by 2018-19.

In total, our adjustments and efficiency challenge resulted in the company's proposed costs being adjusted from £2.011 million over the control period to £1.572 million.

A4.5 Company outcomes, performance commitments and delivery incentives

In the outcomes technical appendix, we discuss our approach to outcomes.

Dee Valley Water did not propose any non-household retail outcomes. However, we are applying the non-household SIM (Wales) that applies to companies operating wholly or mainly in Wales, such as Dee Valley Water. This additional protection is being put in place as the scope for retail competition in Wales is more limited than in England, and so some of these customers will not benefit directly from the protection afforded by competition. As set out in 'Service incentive mechanism (SIM) for 2015 onwards – conclusions', the companies are testing this new measure tested during 2014-15. We therefore have not defined a performance commitment in this draft determination. We will set out the design of this performance commitment and incentive in detail in our final determination.

A4.5.1 Outcome delivery and reporting

In the assurance technical appendix, we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015-2020 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself.

We are satisfied with the company's proposals for self-reporting. But consistent with the commentary in our assurance technical appendix, we will need to consider the categorisation of the company for assurance purposes at the final determination. As noted in section A1.1 we are seeking additional assurance of its representations on its draft determination because of concerns around the quality of information that has been provided.

Dee Valley Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach is summarised in annex 4.

A5. Appointee

In this section, we discuss at an appointee level:

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

A5.1 Bills and K factors

Table A5.1 below sets out the allowed revenues we have assumed in our draft determination for Dee Valley Water to deliver its:

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

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

Table A5.1 Dee Valley Water's draft determination – K factors, allowed revenues and customer bills[A]

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water – allowed revenues (£m)[1]	19.7	19.8	20.0	20.2	20.3	100.0
Wholesale water – K (%)[2]	0.00%	0.72%	0.99%	0.69%	0.69%	-
Retail household allowed revenue (£m)	2.7	2.7	2.7	2.7	2.8	13.6
Retail non-household expected revenue (£m)	0.4	0.4	0.4	0.4	0.4	2.0
Average household bill – water (£)[3]	136	136	136	136	136	-

Notes:

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

We note that customer bills in the regulatory period from 2020 will be affected by Dee Valley Water's performance in the forthcoming regulatory period. This is through both cost performance and performance against the regulatory incentives in place for performance delivery and revenue projection performance.

A5.2 Return on regulated equity range

We set out our approach to calculating the expected range in RoRE in the risk and reward technical appendix. The composition of the RoRE range for Dee Valley Water at an appointee level is shown in Table A5.2 below.

Table A5.2 Whole company RoRE range

	Lower bound (%) (appointee)	Upper bound (%) (appointee)
Overall	-4.2%	+3.0%
ODIs	-0.7%	+0.2%
Totex	-2.5%	+2.2%
Financing	-0.4%	+0.3%
SIM	-0.6%	+0.3%

Commentary

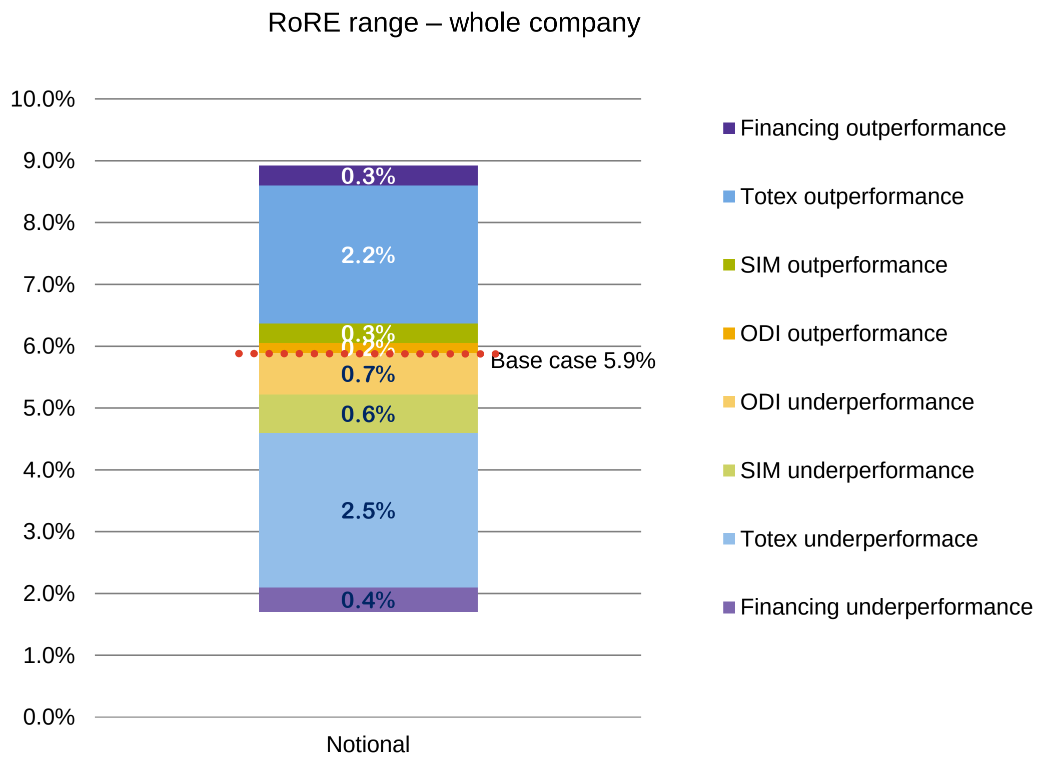
The whole company RoRE range is from 1.6% to 8.9%, with a base case of 5.9%, not including Dee Valley Water's proposed adjustments to the WACC and to the retail margins, with overall impacts from -4.2% to +3.0%.

The totex performance range is -2.5% to +2.2% of notional equity. We are satisfied that Dee Valley Water has appropriately taken into account historic cost variability to arrive at this estimate, which represents a sufficiently considered company view of its totex risk.

The ODI range proposed by Dee Valley Water was from -0.3% to +0.3%. We have adjusted this range to -0.7% to +0.2% to take account of our interventions discussed in annex 4.

Dee Valley Water's financing risk is based on interest rate risk of up to ±0.7% (based on work from its consultants Frontier Economics), while its SIM risk is based on the minimum and the maximum penalty the company might receive under our SIM methodology. We consider this to be reasonable.

Figure A5.1 Dee Valley Water RoRE range – appointee



Source:

Ofwat calculations based on information from Dee Valley Water.

A5.3 Financeability

We have compared the financial ratios provided by Dee Valley Water and our calculation of its financial ratios implied by the company's business plan proposals submitted on 27 June, when both are prepared on a notional basis. We illustrate these in Table A5.3 below. The final column of Table A5.3 sets out the financeability ratios based on our draft determination revenues and costs.

Table A5.3 Company and Ofwat financial ratio calculations based on the company business plan and financial ratios based on our draft determination

Financial ratios for notional company	Financial ratio calculations based on the company business plan (average 2015-20)		Financial ratio calculations based on our draft determination (average 2015-20)
	Company calculation	Ofwat calculation	
Cash interest cover	9.45	3.09	3.25
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	6.07	1.62	1.50
Funds from operations/debt	19.94%	11.86%	10.88%
Retained cash flow/debt	17.15%	8.84%	8.48%
Gearing	68.80%	67.87%	67.65%
Dividend cover (profit after tax/dividends paid)	1.98	1.42	1.35
Regulatory equity/regulated earnings for the regulated company	7.28	12.12	16.03
RCV/EBITDA	7.04	8.29	9.28

Commentary

Financial ratios: Dee Valley Water has a target credit rating (and actual credit rating) of BBB. On an actual and notional basis Ofwat calculated financial ratios and the company's reported ratios are materially lower than Dee Valley Water's ratios. We identified a number of errors in Dee Valley Water's submission, some of which will be drivers of Dee Valley Water's reported ratios being higher than ours. While our ratios are significantly below their calculated ratios, they remain comfortably above investment grade requirements and therefore consistent with the company being financeable on a notional basis for the draft determination.

PAYG changes: Dee Valley Water adjusted its PAYG rates in response to our risk and reward guidance. PAYG represents 91% of opex and IRE and 108% of opex and IRE expensed. Dee Valley Water expense 16% of IRE.

Pass through of WACC reduction: The company proposed a WACC of 4.9%, including a company-specific uplift at December and did not revise this following our risk and reward guidance.

Conclusion on intervention: As we consider the draft determinations to be financeable we do not propose to intervene on financeability. We do not propose to intervene on PAYG as the reduction in the WACC from the removal of the company specific uplift for Dee Valley Water will benefit customers in 2015-20. Dee Valley Water should engage and obtain customer support if it subsequently proposes to change PAYG and RCV run off rates in response to the draft determinations. Any engagement on financeability should be undertaken on the basis of notional financeability. We identified significant issues with the financial data provided by Dee Valley Water during the review of the company business plan and so we require the company to provide Board and additional third party assurance on the calculation of financial ratios and financeability in response to the draft determinations. As part of this the company should also provide Board assurance on the company's ability to deal with the risks that it faces. As noted in section A1.1 we are seeking additional assurance of its representations on its draft determination because of concerns around the quality of information that has been provided.

Table A5.4 sets out the PAYG and RCV run-off rates which shows whether revenue has been brought forward compared with the December plan and the impact that this has on RCV growth and longer-term affordability and financeability. Dee Valley Water has not changed its PAYG or run off rates.

Table A5.4 Impact on the longer term

	PAYG rate	RCV run-off	RCV growth % 1 April 2015 to 31 March 2020
Company December plan	59.0%	6.10%	32.3%
Company June plan	59.0%	6.10%	30.3%
Draft determinations	59.0%	6.10%	27.1%

A5.4 Affordability

Table A5.5 sets out the change in household bill profile between the company's December and June business plans and the draft determinations.

Table A5.5 Household bill profile

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Company December plan	143	147	150	153	155	156
Company June plan	142	146	150	156	158	159
Ofwat calculation for June plan	144	146	154	159	161	162
Ofwat calculation for draft determinations – before reprofiling	144	130	135	137	140	140
Ofwat calculation for draft determinations	144	136	136	136	136	136

Companies have not necessarily used the same method of calculating household bills as Ofwat. For example, we have included economies of scope for household retail when calculating combined water and sewerage bills. So the Ofwat calculations (lines 3, 4 and 5 of Table A5.5) are not directly comparable to the company plans (lines 1 and 2 of Table A5.5). Our interventions have reduced revenue and bill requirements over 2015-20. In the absence of customer preferences for bill profiles at this level we have reprofiled bills so that there is a reduction in the first year with flat bills for the remainder of the period.

We invite Dee Valley Water to engage with its customers on their priorities for bills as part of its response to the draft determinations.

Table A5.6 sets out the reasons why this draft determination is assessed as affordable. It describes key changes in relation to Dee Valley Water's December business plan that we assessed as affordable.

Table A5.6 Business plan affordability assessment

	Commentary
Acceptability	In its December plan, Dee Valley Water's acceptability research concluded that 71% of its customers found the company's proposals acceptable. However, in our risk-based review assessment we concluded that, because of the relatively low levels of acceptability, issues with presentation of inflation, and the failure of the company to

	Commentary
	sufficiently identify customers who found its plan unacceptable, the company had not satisfactorily demonstrated that its plan was affordable. To address our concerns, Dee Valley Water carried out some additional acceptability research in May 2014, which found that 75% of those surveyed found the company's proposals acceptable.
Identification of affordability issues and appropriate support measure	For those customers experiencing affordability problems, Dee Valley Water provides help through a number of measures including access to the WaterSure tariff; bespoke payment terms; debt advice; water efficiency advice; and free meter option. To provide further support Dee Valley Water is proposing to introduce a social tariff in the next control period. Dee Valley has provided more details about its proposed social tariff in its June business plan submissions. There is no evidence that the scope or scale of these measures has been reduced in the revised plan.
Longer-term affordability – cost recovery tools	In our analysis of the company's December plan we concluded that the company had not provided enough evidence to convince us that its use of the PAYG and RCV run-off levers would not lead to a risk of affordability problems for customers in the long term. In the revised plan, both the PAYG and RCV run-off ratios are unchanged, and the company provides an explanation that its cost recovery tools will not lead to affordability problems in the longer term.
Longer-term affordability – ODIs	Dee Valley Water has provided sufficient and convincing evidence that it has updated its package of ODI's in order to reflect the revised risk and reward guidance. In particular, in the case of four existing performance measures, the company has replaced reputational incentives with penalty/reward incentives. In addition, an entirely new measure has been added which has also been allocated a penalty/reward incentive. The Customer Challenge Group expresses its support for the revised ODI package.

Annex 1 Wholesale costs

Establishing draft determination thresholds

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

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

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

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

Basic cost threshold	Policy additions[1]	Unmodelled costs adjustment	Deep dive	Draft determination threshold	Deep dives fully or partially not added[2]
73.1	6.7	-1.4	13.5	**91.9**	14

Note:

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

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

Business rates	Pension deficit payments	Third party costs	Open market costs	Net v gross adjustments	Total
5.1	0.9	0.7	0.0	0.0	**6.7**

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

Plan	DD threshold	Gap[1]	Plan v 2010-15
103.0	91.9	11.2	21.0

Note:

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

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

Company proposal		Assessment				DD allowance	
Claim	Amount sought	Implicit allowance	Need	CBA	Robust costs	Assessment	Amount allowed
Legacy Treatment Works	17.1	5.7	Pass	Pass	Pass	Accept	11.4
SDB	1.1	1	n/a	n/a	n/a	Partially accept	0.5
Permit Scheme for Road and Street Activities in CWaC Area	1	0.3	Pass	Pass	Partial Pass	Partially accept	0.6
Scale Effects	2.3	0.4	Pass	n/a	Partial Pass	Partially accept	0.9
Service Reservoir Water Quality Risk Management	8.3	2.7	Pass	Pass	Fail	Reject	0
Reservoir Safety	1.2	0.4	Pass	Pass	Fail	Reject	0
IT Upgrade	1	0.3	Partial pass	Fail	Fail	Reject	0
Barrelwell Hill Refurbishment	0.7	0.2	n/a	n/a	n/a	Reject	0
Wrexham Pumping Station Upgrade	0.8	0.3	Fail	Pass	Fail	Reject	0

Company proposal		Assessment				DD allowance	
Claim	Amount sought	Implicit allowance	Need	CBA	Robust costs	Assessment	Amount allowed
Caustic Plant	0.9	0.8	n/a	n/a	n/a	Reject	0
Mains Cleaning Programme	0.8	0.2	n/a	n/a	n/a	Reject	0
Sludge Handling	1	0.3	Fail	Fail	Fail	Reject	0
Oerog Improvements	0.6	0.2	n/a	n/a	n/a	Reject	0
Mains Renewal Programme	2.8	0.9	Fail	Pass	Fail	Reject	0
Water Treatment Complexity	1.3	0.4	Fail	n/a	Fail	Reject	0

Note:

1. If the company makes any representations in relation to these assessments, we require it to provide third party assurance, including over the robustness and efficiency of any costs.
2. In its June submission the company also included representations on the totex models. Our analysis and conclusions on this claim have been set out in annex 1 to the wholesale water and wastewater technical appendix.

Annex 2 Household retail revenue modification

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

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

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

Revenue modification per:	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only customer	21.46	21.24	20.89	20.60	20.73
Metered water only customer	24.51	24.31	23.97	23.71	23.85

Note:

There will be no indexation for retail price controls.

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

Number of customers	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only	47.8	46.3	44.8	43.4	42.0
Metered water only	69.4	71.9	74.3	76.7	79.1

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Annex 3 Reconciling 2010-15 performance

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

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

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

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

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

	Company view	Ofwat view
Service incentive mechanism (SIM)	-0.035	-0.113
Revenue correction mechanism (RCM)	4.900	5.023
Opex incentive allowance – post-tax (OIA)	0.000	0.000
Capital expenditure incentive scheme (CIS)	-1.005	-1.035
Tax refinancing benefit clawback	0.000	0.000
Other tax adjustments	0.000	0.000
Equity injection clawback	0.000	0.000
Other adjustments	0.000	0.000
Total wholesale legacy adjustments	3.860	3.875

Notes:

Totals may not add up due to rounding.

For the CIS mechanism, there is a corresponding adjustment to the RCV made at 1 April 2015 (part of the 'midnight' adjustments'). The impact on the RCV for water can be seen in Table AA3.15. This adjustment is net of any logging up, logging down or shortfalls. A full reconciliation showing all of the midnight adjustments to the RCV, including the impact of logging up, logging down and shortfalls, can be seen in Table A2.5.

Service incentive mechanism (SIM)

We provide our view of each company's SIM reward/penalty in the wholesale water and wastewater technical appendix. In assessing the scale of this penalty, we have taken into account the survey data error that occurred in the Q4 2013-14 SIM. We consider that this survey data error was beyond the company's control and should be appropriately recognised. Ofwat's view of the scale of this error is smaller than the company has stated.

Table AA3.2 provides the annualised rewards from the company's SIM performance.

Table AA3.2 SIM annualised rewards (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-0.007	-0.007	-0.007	-0.007	-0.007	-0.035
Ofwat view	-0.023	-0.023	-0.023	-0.023	-0.023	-0.113

Revenue correction mechanism (RCM)

This draft determination includes our view of the company's RCM annualised adjustment amounts as detailed in Table AA3.3 below.

Table AA3.4 summarises our interventions in relation to Dee Valley Water's proposed 2010-15 RCM adjustments.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	0.98	0.98	0.98	0.98	0.98	4.9
Ofwat view	1.005	1.005	1.005	1.005	1.005	5.023

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

Area of intervention	What we did	Why we did it
Forecast 2014-15 tariff basket revenue	We have restricted the revenue shortfall in 2014-15 to the level recorded in 2013-14.	The company did not explain the reasons for a widening difference between its 2014-15 forecasted revenue and its FD09 revenues forecast compared to previous years variances seen in 2013-14 and earlier years.
FD09 assumptions	Our draft determination includes our view of the FD09 assumptions for the inputs to the RCM model.	There are inconsistencies between the company's and our view of the FD09 assumptions used in the company's populated RCM model.
Number of households billed	Our assumptions for the draft determination use the data the company submitted in business plan table R3 to calculate our view of the RCM adjustment.	There were inconsistencies with the number of households billed between business plan table R3 and the company's populated RCM model.

Area of intervention	What we did	Why we did it
Net revenue movement out of tariff basket in 2009-10	Our assumption for the draft determination uses the data the company submitted in business plan table W17 to calculate our view of the RCM adjustment.	There were inconsistencies with the amount submitted between business plan table W17 and the company's populated RCM model.
Number of non-households billed	Our assumptions for the draft determination use the data the company submitted in business plan table W17 to calculate our view of the RCM adjustment.	There were inconsistencies with the number of non-households billed between business plan table W17 and the company's populated RCM model.

Operating expenditure incentive allowance (OIA)

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

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

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

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

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

Change protocol (logging up, logging down and shortfalls)

Table AA3.7 and Table AA3.8 below summarise Dee Valley Water's view and our baseline view of total adjustments to:

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

Table AA3.9 summarises our interventions in relation to Dee Valley Water's proposed change protocol adjustments.

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

2009-10 to 2014-15 – post-efficiency capex	Company view	Ofwat view
Logging up (two sided)	0.370	0.370
Logging down (two sided)	0.000	0.000
Shortfalls (one sided)	0.000	0.000

Notes:

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

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

2009-10 to 2014-15 – post-efficiency opex	Company view	Ofwat view
Logging up	0.206	0.206
Logging down	0.000	0.000
Shortfalls	0.000	0.000
Shortfalls for serviceability	0.0	0.0

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

Area of intervention	What we did	Why we did it
Wrexham Ring Main – Logging up	There are no interventions for this scheme.	We are accepting the company’s proposed logging up claim.

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

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

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

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

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

Serviceability performance

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

Table AA3.10 Serviceability assessments for 2010-15[1]

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

Notes:

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

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

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

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

Area of intervention	What we did	Why we did it
Discolouration contacts (orange/brown/black)	For the purposes of the draft determination we have assumed no intervention. This is conditional upon the evidence that the performance in 2014-15 is likely to be improved to a position such that it could be considered as stable. We may consider a shortfall adjustment if this is not achieved. **We would expect the company to demonstrate its latest performance as part of its representations and in advance of the final determination.**	The company has experienced discolouration contacts above the upper control limit for a significant part of the 2010-15 period. The cause of this discolouration has been linked to raw water deterioration at the input to the treatment works (in the village of Legacy) resulting in increased manganese levels being output from the works. The DWI has instigated an undertaking to respond to this issue within the 2010-15 period. The company has undertaken trunk main and distribution main cleaning in accordance with this undertaking and has completed this by December 2013. Based upon the query information provided by the company we consider there has been an improvement in discolouration performance from January 2014 onwards. Based upon this information we are not seeking to apply a shortfall as part of the draft determination, conditional upon the performance data for 2014 (calendar year) being stable. We will reconsider this position before our final determination in November, by which time the company should be able to supply us with nearly 10 months data for the 2014 calendar year.

Area of intervention	What we did	Why we did it
Water treatment works coliforms non-compliance	For the purposes of the draft determination we have assumed no intervention. This is conditional upon the performance 2014-15 being improved to a position such that it could be considered as stable. We may consider a shortfall adjustment if this is not achieved. **We would expect the company to demonstrate its latest performance as part of its representations and in advance of the final determination.**	The company's performance has remained close to or at the upper control limit in 2010-11 and 2012-13 and has remained above the reference level in the remaining years. The company has forecast 2014-15 to outturn at same level as 2013-14. We require the company to demonstrate stable serviceability in 2014-15, if this is not achieved, we may consider a shortfall adjustment.

Note:

The shortfall calculation methodology is detailed in the wholesale water and wastewater technical appendix.

The 2009 agreed overlap programme

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

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

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

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

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

Capital expenditure incentive scheme (CIS)

Table AA3.15 provides details of the CIS ratios and performance incentive. It also gives the:

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

Table AA3.16 then sets out the profiled values of the revenue adjustments in each year 2015-20.

Table AA3.15 Legacy true-up adjustments

		Water service
Restated FD09 CIS bid ratio	Company view	98.958
	Ofwat view	98.956
Outturn CIS ratio	Company view	96.541
	Ofwat view	96.763
Incentive reward/penalty (%)	Company view	1.075
	Ofwat view	1.006
Reward/penalty (£m)	Company view	0.381
	Ofwat view	0.356
Adjustments to 2015-20 revenue (£m)	Company view	-0.934

		Water service
	Ofwat view	-0.964
CIS adjustment to RCV (£m)	Company view	-2.815
	Ofwat view	-2.817

Commentary

The company broadly applied the published Ofwat methodology. However, we identified some inconsistencies between the indexation inputs in the CIS model and table A9 of the revised business plan.

In carrying out our assessment, we have:

- used the values submitted in table A9 in the CIS model;
- profiled the revenue adjustment using the same profiling approach as the company; and
- included our view of the applicable change protocol amounts.

Notes:

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

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

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

Table AA3.16 Profiled revenue adjustments from the CIS reconciliation (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-0.201	-0.201	-0.201	-0.201	-0.201	-1.003
Ofwat view	-0.207	-0.207	-0.207	-0.207	-0.207	-1.035

Other adjustments

Table AA3.17 below confirms the assumptions included in this draft determination with respect to the following adjustments:

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

Table AA3.17 Other adjustments 2015-20 (£ million)

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

Annex 4 Outcomes, performance commitments and outcome delivery incentives

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

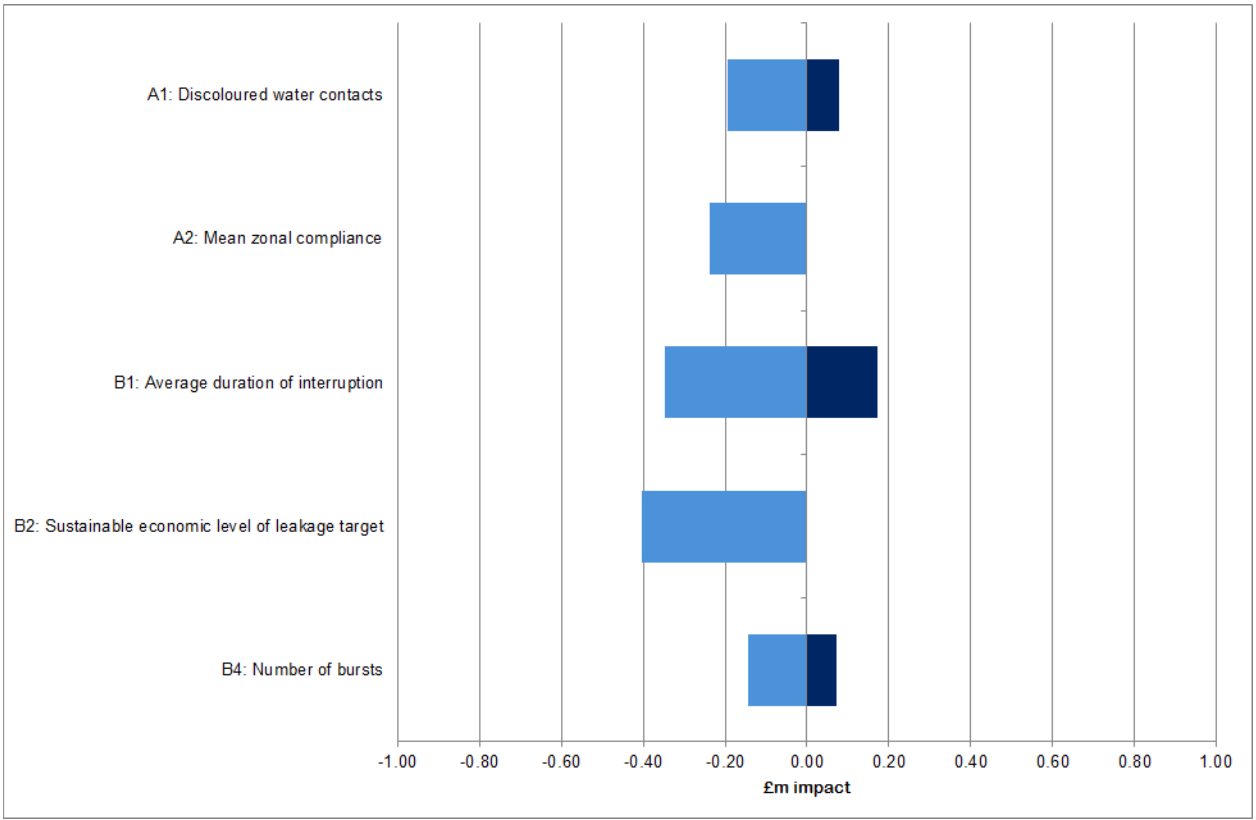
The table and figure below first provide an overview of these performance commitments and ODIs. Table AA4.1 shows the balance between reward and penalty, penalty only and reputational incentives in the package of incentives for the company and Figure AA4.1 shows the potential financial impact of each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

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

	Reward and penalty	Penalty only	Non-financial incentive
Wholesale water	4	2	3
Household retail	1	0	1
Total	5	2	4

The following figure shows the potential financial consequences of the individual financial ODIs. The figures represent the penalties and rewards associated with the p10 and p90 scenarios over the five years (2015-16 to 2019-20). This means there is a 10% chance of performance being higher or lower than these assumed levels. In most cases the potential maximum will be bigger but is very unlikely to occur. The p10 and p90 therefore represent a more realistic estimate of potential financial consequences.

Figure AA4.1 Overview of financial ODIs



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

There are a small number of specific exclusions from the cap/collar. For Dee Valley Water the exclusions are as follows:

- A3: Legacy treatment works

Table AA4.2 sets out a more detailed explanation of our interventions in the company's wholesale water outcomes. We have not intervened in its household retail outcomes.

Table AA4.2 Summary of interventions on wholesale water outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
A1 – Discoloured water contacts	Following horizontal consistency check, reduce PC level to 0.93 complaints per 1,000 population in years 3, 4 and 5 Also, adjust PC level in year 2 as well as deadbands and caps and collars.	**Horizontal consistency check** As set out in the outcomes technical appendix we have set the performance commitment level at upper quartile for all companies' water quality contacts performance commitments in years 3, 4 and 5. Because Dee Valley Water's performance commitment only represents discoloured water contacts we have adjusted the upper quartile estimate for all contacts (1.22/1,000 population) to reflect this. This was done by setting the level based on the proportion of all contacts in 2013 that related to discoloured water. We have also set deadbands and caps and collars consistent with the approach described in the outcomes technical appendix.
A2 – Mean zonal compliance	Following horizontal consistency check, increase PC level and penalty deadband in years 3, 4 and 5 to 100% and 99.96% respectively Also, move the penalty deadband up to 99.93% in years 1 and 2	**Horizontal consistency check/penalty deadband not sufficiently justified** As set out in the outcomes technical appendix we have set the performance commitment level at 100% compliance for all companies' mean zonal compliance performance commitment in years 3, 4 and 5. We have also set penalty deadbands at 99.96% to reflect upper quartile performance, with allowance for some uncertainty and company-specific factors. Furthermore, according to Dee Valley Water's historical data, performance only dropped below 99.93% twice in the last ten years but has been consistently at or above 99.93% since 2011. This level is at the bottom of the industry. We are therefore also moving the

PC/ODI affected	What we did	Why we did it
		deadband up to 99.93% in years 1 and 2 to better protect customers. The Company has defined Outcome Delivery Incentives for drinking water quality compliance with a penalty at less than 100%. This penalty represents an incentive to the company to not reduce its compliance with water quality measures. This threshold represents the point at which financial incentives will be applied to the company through the price setting process. All companies are subject to drinking water quality obligations regulated by the DWI, which are the overriding statutory obligations that a water company must comply with as part of their Section 37 obligations. The company's Board has confirmed as part of its business plan submission that it will comply with all relevant statutory obligations.
A3 – Legacy Treatment Works	Introduce PC and ODI related to delivery of improvements at Legacy Treatment Works	Our rationale for this intervention is set out in table AA4.6. **We require Dee Valley Water to put forward its own PC/ODI relating to this investment in its representation that would fully protect customers in time for its final determination.**
B1 – Average duration of interruption	Clarify definition of performance commitment Change from non-financial incentive to reward and penalty financial incentive Adjust performance commitment level to 0.17 hours in years 3, 4 and 5 to represent upper quartile	**Horizontal consistency check/Incentive not sufficiently justified** It is unclear whether the performance commitment accounts for all supply interruptions, or those greater than three hours. Based on Dee Valley Water's historical data, we therefore specify the commitment relates to the total hours lost due to interruptions for three hours or longer, per property. There is insufficient evidence of why a non-financial incentive is appropriate for this measure. We are therefore setting a financial

PC/ODI affected	What we did	Why we did it
	performance Adjust performance commitment levels in years 1 to 2 as well as introduce deadbands, caps and collars to align with upper quartile adjustments	incentive with reward and penalty for this measure in order to encourage the company to deliver improvements and better protect customers. We have set the incentive based on customer WTP from Dee Valley Water's customer research. As set out in the outcomes technical appendix we have set the performance commitment level at upper quartile (ten minutes per property) for all companies' supply interruptions performance commitments in years 3, 4 and 5. We have also set deadbands and caps and collars consistent with the approach described in the outcomes technical appendix
B2 – Sustainable Economic Level of Leakage target	Increase the penalty incentive rate, such that incentive rate is now: £5,150/(l/property/day)/yr	**Penalty rate not sufficiently justified** Dee Valley Water has set its penalty incentive rate using the formula from appendix 1 of the July methodology statement. However, because the incremental costs (£6,145) associated with under-delivery exceed WTP (£4,155) it does not provide appropriate incentive properties (ie, the penalty incentive rate does not exceed the company share of avoidable incremental cost). We have therefore recalculated the penalty incentive rate to provide stronger protection for customers. We have set the incentive as incremental totex adjusted for totex efficiency sharing plus a premium based on WTP to compensate customers. Hence, we calculate the penalty rate as the sum of half incremental cost and half of incremental WTP, as follows. ODI penalty = (incremental costs x 0.5) + (incremental WTP x 0.5)

PC/ODI affected	What we did	Why we did it
		= (£6145*0.5) + (£4155*0.5) = £5,150 (l/property/day)/yr
B4 – Number of bursts	Adjust the PC level to the average of the performance over 2010-15 (222), with accompanying incentives and deadbands adjusted by an equivalent amount.	**Performance commitment not sufficiently justified** Dee Valley Water propose to maintain the number of bursts at the reference level of 260 over 2015-20. However, Dee Valley Water regularly outperformed this figure over 2010-15 and have predicted the number of bursts in 2014-15 will be 211. There is no evidence offered as to why the company cannot maintain a similar performance level in the future. We are therefore setting the PC level at the average number of bursts during 2010-15. We have also adjusted deadbands and caps and collars to reflect the adjustment to the PC level.
D1 – Customers' perception based on market research	Clarify that performance commitment is to deliver improved levels of customer perception each year following setting the baseline in 2015-16	**Performance commitment not sufficiently clarified** Dee Valley Water states that it will undertake a number of surveys with customers in 2015-16 to determine customer perception of value for money and affordability of bills. We have therefore clarified that Dee Valley Water will do this to set a baseline target. We then expect it to improve customer perception each year.

Table AA4.3 Summary of interventions on household retail outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
We have not intervened on the company's household retail outcomes performance commitments and incentives.		

Outcome delivery and reporting

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

The table below summarises Dee Valley Water's proposed approach to the measurement, reporting and governance of outcomes and our assessment of this approach.

Table AA4.4 Dee Valley Water's proposals for outcome delivery and reporting

Dee Valley Water proposals	Our assessment
Dee Valley Water sets out full details of its approach to outcome delivery and reporting in section 2.2 of its business plan 'Outcome delivery incentive governance arrangement' as well as providing ODI-specific reporting throughout section 2 'Consultations, obligations and outcomes' In order to ensure transparent reporting of results Dee Valley Water states that "we will publish, on an annual basis, our progress on achieving our performance commitments. This report will be published on our website and, in order to maximise the awareness of our performance commitment reporting, we will include an appropriate message on our bills." To ensure appropriate governance and quality assurance Dee Valley Water states that "Prior to publication we will ensure that our performance commitment measurement and reporting is subject to audit by our Technical Auditor… [and] will report to the Audit committee… The Audit committee will ensure it meets with the Technical Auditor without any executive directors present in order to discuss any areas of concern on a confidential basis." Dee Valley Water also proposes that "we will	In our methodology statement we set out our expectation that companies should demonstrate that their proposed PCs can be measured and recorded consistently and that they will have the appropriate governance and quality assurance processes in place to achieve this. We also expect companies to be transparent with customers about their performance against their outcomes and commitments. Dee Valley Water has provided sufficient evidence demonstrating the approach it will undertake to ensure the PCs will be measured and reported consistently, and the proposed governance and assurance processes. Therefore, we have accepted the company's proposal. In time, we may develop further information requirements with regard to outcomes, as we review and change current requirements relating to performance indicators and each company's annual risk and compliance statement.

Dee Valley Water proposals	Our assessment
review our progress on achieving them with our Customer Challenge Panel. We will also ensure that our key stakeholders, including Ofwat, Welsh Government, CC Water, DWI and Natural Resources Wales, are fully informed of our progress on achieving our performance commitments." To ensure accountability Dee Valley Water states that "Ultimately the Chief Executive, supported by his senior management team, is accountable to the Board and external stakeholders for meeting our performance commitments. He will be responsible for ensuring that progress on achieving our performance commitments is reported at each scheduled Board meeting… the Board's remuneration committee has developed and implemented an executive bonus scheme for executive directors and other senior executives which directly links their remuneration to the standards of performance experienced by customers".	

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

- The name and detailed definition of the performance commitment.
- The type of incentive.
- The performance commitment level.
- For financial incentives:
    - the limits on rewards and penalties (caps and collars) and neutral zones (deadbands) as applicable[2]; and
    - the incentive rates.

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

- Additional details on the measure.
- Where Ofwat has not accepted the company's proposals, the nature of the intervention made is also explained.

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

We have intervened in relation to a number of performance commitments proposed by the company. Where our intervention is to remove the performance commitment in question, details and reasoning are provided in Table AA4.5. Where we have amended the company's proposed incentive but retained the performance commitment, we have intentionally set out our interventions below using a ~~strikethrough~~. What this means is that we have rejected the proposal that has been struck through and instead we have either used a different value or not included a value at all (for example, in the case of some rewards).

Dee Valley Water will be able to finalise its proposed menu choice and affected ODI calibrations following our consideration of responses to these proposals.

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

Performance commitment	Reason for its removal
Wholesale water	
n/a	n/a
Wholesale wastewater	
n/a	n/a
Household retail	
n/a	n/a

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

Performance commitment	Reason for its addition
Wholesale water	
Legacy Treatment Works – introduce PC and ODI related to delivery of improvements at Legacy Treatment Works	**Insufficient customer protection** Dee Valley Water proposed a special wholesale cost claim for upgrading Legacy Treatment Works, with two main drivers; maintenance to address the asset deterioration and therefore increased risk to service and to address the various water quality issues (primarily raw water deterioration and the impact that has had on the network). At the risk-based review we scored the customer protection aspect of our assessment as a partial pass. However, with Dee Valley Water's removal of its two serviceability measures we are concerned that the measures relating to discoloured water complaints and mean zonal compliance do not fully protect customers from failure to deliver this upgrade. We have therefore introduced a PC relating specifically to delivery of this upgrade. The ODI has been set at 50% of the implicit allowance relating to these upgrades. This compensates customers for the financial aspect of the investment while the discoloured water and mean zonal compliance PCs will compensate customers for the value lost through delay or non-delivery of the project. **We require Dee Valley Water to put forward its own PC/ODI relating to this investment in its representation that would fully protect customers in time for its final determination.**

Wholesale water outcome 1: Provide excellent water quality

Performance commitment A1: Discoloured water contacts

Detailed definition of performance measure: The number of contacts received per 1,000 population regarding orange, brown or black discolouration of their water supply.

Incentive type: Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Number of complaints per 1,000 population	3.69	2.72	1.85 ~~2.52~~	0.93 ~~2.32~~	0.93 ~~2.12~~	0.93 ~~1.92~~
Penalty collar	Number of complaints per 1,000 population		5.89	5.69	3.30 ~~5.49~~	3.30 ~~5.29~~	3.30 ~~5.09~~
Penalty deadband	Number of complaints per 1,000 population		3.52	3.32	0.93 ~~3.12~~	0.93 ~~2.92~~	0.93 ~~2.72~~
Reward deadband	Number of complaints per 1,000 population		0.93 ~~1.92~~	0.93 ~~1.72~~	0.93 ~~1.52~~	0.93 ~~1.32~~	0.93 ~~1.12~~
Reward cap	Number of complaints per 1,000 population		0.00	0.00	0.00	0.00	0.00

Incentive rates

Incentive type	Performance levels (number of complaints per 1000 population)		Incentive rate (£/complaint per 1000 population/year)
	Lower	Upper	
Penalty	>0.93 ~~2.72~~	5.89	30,586
Reward	0.00	<0.93 ~~1.92~~	24,934

Additional details

Necessary detail on measurement units	The Drinking Water Inspectorate, a regulator dedicated solely to the objective of drinking water quality, monitors the company's performance closely and reports publicly on the company's performance along with other companies.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Annual
Form of reward/penalty	AMP7 Revenue adjustment ~~RCV~~
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment A2: Mean zonal compliance

Detailed definition of performance measure: The proportion of tests within samples taken at the company's water treatment works (WTWs), service reservoirs (SRs) or customers' taps that have passed in the year, that is, the % of sample tests that are compliant with all required standards.

Incentive type: Financial – penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	99.96	99.96	99.96	100 ~~99.96~~	100 ~~99.96~~	100 ~~99.96~~
Penalty collar			n/a	n/a	n/a	n/a	n/a
Penalty deadband			99.93 ~~99.91~~	99.93 ~~99.91~~	99.96 ~~99.91~~	99.96 ~~99.91~~	99.96 ~~99.91~~

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£k/year)
	Lower	Upper	
Penalty	n/a ~~99.91~~	<99.96	47.4

Additional details

Necessary detail on measurement units	The DWI Chief Inspector's Annual Report publishes a list of the total number of tests taken at the company's WTWs, SRs or at customers taps and identifies how many test failures have occurred. This gives the % compliance on test samples.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Annual
Form of reward/penalty	AMP7 Revenue adjustment ~~RCV~~
Any other information or	This is a pass/fail incentive type. In each year where

clarifications relevant to correct application of incentive	performance drops below the penalty deadband the full penalty will apply.

Performance commitment A3: Legacy Treatment Works

Detailed definition of performance measure: Completion of improvements at Legacy Treatment Works relating to the W11 special claim

Incentive type: Financial – penalty only.

Performance commitments

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

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£m)
	Lower	Upper	
Penalty	n/a	Incomplete	5.7

Additional details

Necessary detail on measurement units	Performance to be measured as pass/fail.
Frequency of PC measurement and any use of averaging	Progress to be reported annually with project completion to be assessed in 2019-20
Timing and frequency of rewards/penalties	Assessed in 2019-20
Form of reward/penalty	RCV adjustment
Any other information or clarifications relevant to correct application of incentive	This is a pass/fail incentive type. If project is not complete by the end of 2019-20 the full incentive will apply

Wholesale water outcome 2: Provide reliable and high quality customer service

Performance commitment B1: Average duration of interruption

Detailed definition of performance measure: ~~Average duration of supply interruption~~ The total hours lost due to interruptions for three hours or longer, per property within the company's supply area (includes both planned and unplanned interruptions)

Incentive type: ~~Reputation only~~ Financial – reward and penalty

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Hrs/property	0.33	0.28 ~~0.33~~	0.22 ~~0.33~~	0.17 ~~0.33~~	0.17 ~~0.33~~	0.17 ~~0.33~~
Penalty collar	Hrs/property		0.50	0.50	0.33	0.33	0.33
Penalty deadband	Hrs/property		0.33	0.33	0.17	0.17	0.17
Reward deadband	Hrs/property		0.17	0.17	0.17	0.17	0.17
Reward cap	Hrs/property		0	0	0	0	0

Incentive rates

Incentive type	Performance levels (hrs/property)		Incentive rate (£/0.01hrs/year)
	Lower	Upper	
Penalty	0.17	0.50	4,178.36

Incentive type	Performance levels (hrs/property)		Incentive rate (£/0.01hrs/year)
Reward	0	0.17	2.087.04

Additional details

Necessary detail on measurement units	~~Average duration of loss of supply due to water supply interruptions (planned and unplanned)~~ The calculation of reward or penalty will use the actual number of minutes calculated to 2 decimal places. Total hours interruption (planned and unplanned) is divided by the number of properties (domestic and non-domestic) connected for water supply.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Annually ~~n/a~~
Form of reward/penalty	AMP7 Revenue adjustment ~~n/a~~
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment B2: Sustainable economic level of leakage target

Detailed definition of performance measure: The total level of leakage, including customer supply pipe leakage, expressed in litres/prop/day for the calendar year; calculation as defined for the Ofwat KPI in IN 13/03.

Incentive type: Financial – reward and penalty

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	l/prop/day	90.8	90.8	90.8	90.8	90.8	90.8
Penalty collar	l/prop/day		121.6	121.6	121.6	121.6	121.6
Penalty deadband	l/prop/day		90.8	90.8	90.8	90.8	90.8
Reward deadband	l/prop/day		76.1	76.1	76.1	76.1	76.1
Reward cap	l/prop/day		60.0	60.0	60.0	60.0	60.0

Incentive rates

Incentive type	Performance levels (l/prop/day)		Incentive rate (£/l/prop/day/year)
	Lower	Upper	
Penalty	90.8	121.6	5,150.43 ~~1,976.38~~
Reward	60.0	76.1	1,976.38

Additional details

Necessary detail on measurement units	The target has been calculated using the industry standard economic level of leakage methodology.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Annual
Form of reward/penalty	AMP7 Revenue adjustment

	~~RCV~~
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment B3: Security of supply index

Detailed definition of performance measure: Indicates the extent to which a company is able to guarantee provision of its levels of service for restrictions of supply. The indicator measures security of supply for two scenarios (where relevant) – under dry year annual average conditions and peak demand conditions.

Incentive type: Reputation only

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Index (%)	100	100	100	100	100	100

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£m/%/year)
	Lower	Upper	
Reputational	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	Maintain the security of supply index at 100 over 2015-20
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of	n/a

rewards/penalties	
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment B4: Number of bursts

Detailed definition of performance measure: Number of bursts per year

Incentive type: Financial – Reward and penalty

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	bursts	211	222 ~~258~~	222 ~~258~~	222 ~~258~~	222 ~~258~~	222 ~~258~~
Penalty collar	bursts		314 ~~350~~	314 ~~350~~	314 ~~350~~	314 ~~350~~	314 ~~350~~
Penalty deadband	bursts		292 ~~328~~	292 ~~328~~	292 ~~328~~	292 ~~328~~	292 ~~328~~
Reward deadband	bursts		152 ~~188~~	152 ~~188~~	152 ~~188~~	152 ~~188~~	152 ~~188~~
Reward cap	bursts		130 ~~166~~	130 ~~166~~	130 ~~166~~	130 ~~166~~	130 ~~166~~

Incentive rates

Incentive type	Performance levels (No. of bursts)		Incentive rate (£/burst/year)
	Lower	Upper	
Penalty	292	314	1,301.36

Incentive type	Performance levels (No. of bursts)		Incentive rate (£/burst/year)
	~~328~~	~~350~~	
Reward	130 ~~166~~	152 ~~188~~	650.68

Additional details

Necessary detail on measurement units	Mains bursts as defined in BoN ref BN 1225
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Annual
Form of reward/penalty	AMP7 Revenue adjustment ~~RCV~~
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome 3: Minimise the environmental impact

Performance commitment C1: Gross operational greenhouse gas emissions

Detailed definition of performance measure: Measurement of the annual operational GHG emissions of the regulated business.

Incentive type: Reputation only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	tCO_2e	9889	9783	9762	9752	9740	9727

Incentive rates

Incentive type	Performance levels (tCO_2e)		Incentive rate (£/tCO_2e/yr)
	Lower	Upper	
Reputational	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	Greenhouse gas emissions based on the UKWIR carbon accounting workbook used to populate June Return Table 42
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome 4: Provide a value for money service

Performance commitment D1: Customers' perception based on market research

Detailed definition of performance measure: Customer scores for value for money and affordability of bills.

Incentive type: Reputation only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	TBC	Set target ~~TBC~~	Improved ~~TBC~~	Improved ~~TBC~~	Improved ~~TBC~~	Improved ~~TBC~~

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£/%)
	Lower	Upper	
Reputational	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	Customer satisfaction surveys to be carried out in accordance with MRS Code of Conduct and SRA ethical guidelines. The market research will be taken out in 2015-16.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of	n/a

rewards/penalties	
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	n/a

Household retail outcome 1: Provide reliable and high quality customer service

Performance commitment E1: Per capita consumption and water efficiency

Detailed definition of performance measure: Average per capita consumption.

Incentive type: Reputation only

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	l/hd/day	132.39	131.44	130.45	129.44	128.37	127.28

Incentive rates

Incentive type	Performance levels (l/hd/day)		Incentive rate (£/l/hd/day/year)
	Lower	Upper	
Reputational	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	Per capita consumption as measured by household consumption divided household occupancy (Table 10b(i) Line 31
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a

Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment E2: Service incentive mechanism

Detailed definition of performance measure: SIM score as defined in Ofwat's SIM guidance April 2012 and updated by IN 13/03

Incentive type: Reward and penalty

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Industry score	80	80	80	80	80	80
Penalty collar	Industry score		Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology
Penalty deadband	Industry score		Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology
Reward deadband	Industry score		Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology
Reward cap	Industry score		Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology	Ofwat methodology

Incentive rates

Incentive type	Performance levels (SIM Score)		Incentive rate (£m/Score/year)
	Lower	Upper	

Incentive type	Performance levels (SIM Score)		Incentive rate (£m/Score/year)
Penalty	Ofwat methodology	Ofwat methodology	Ofwat-led price control adjustments that are implemented at price reviews
Reward	Ofwat methodology	Ofwat methodology	Ofwat-led price control adjustments that are implemented at price reviews

Additional details

Necessary detail on measurement units	All companies report and Ofwat publish an annual industry SIM score.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported on an annual basis through the Company's Key Performance Indicator report.
Timing and frequency of rewards/penalties	Any reward or penalty will be applied at the end of the regulatory period 2015-20.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	n/a

2

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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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