

August 2014

Setting price controls for 2015-20
Draft price control determination notice:
company-specific appendix – Portsmouth Water



OFWAT

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Overview

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

Portsmouth Water's business plan has many strengths. The company had less significant issues to address following the risk-based review compared to many other companies, and it was already below our calculated thresholds for wholesale and retail costs. Accordingly we have only needed to make select interventions in the company's business plan to safeguard the interests of customers. Some of these interventions are 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 Portsmouth Water, along with what they mean for average customer bills. We have summarised this information in the 'draft determination – at a glance'. 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 price 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 and in particular those provided for by the Water Act 2014.

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

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

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

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

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

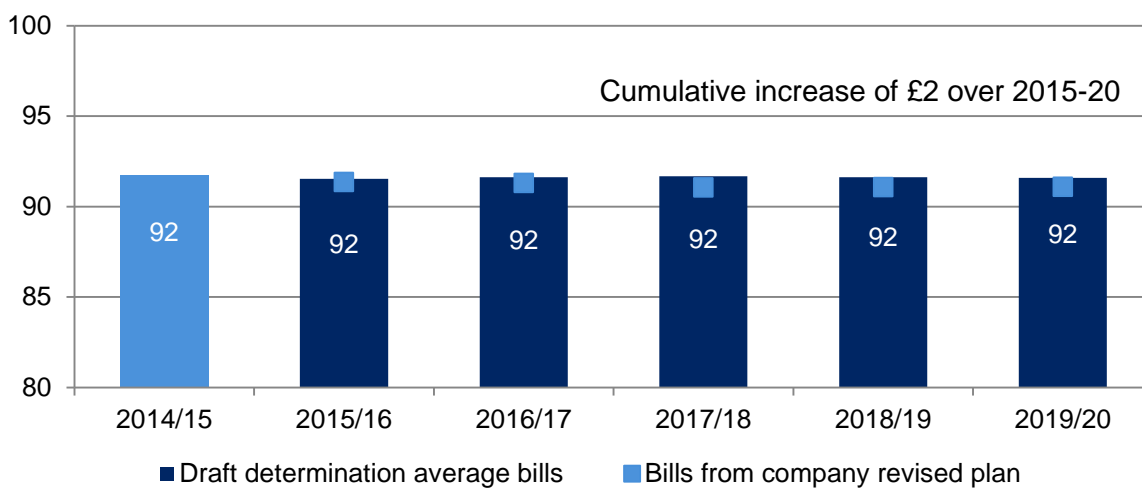
Annexes 1 to 4 form part of the draft price control determination.

A1. draft determination – at a glance

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

- for customers, with respect to the average bills they will pay and the outcomes that the company will deliver in return; and
- for the company, with respect to the allowed costs/expenditure, return on regulatory equity (RoRE) 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

A safe, secure and reliable supply of drinking water

Customers recognise that we provide a high quality service and value for money

An improved environment supporting biodiversity, public amenities and recreation

Proving attractive to investors by providing a long term financially sustainable business

Recognised by stakeholders as having a culture of health and safety through all our activities

Retail

Customers recognise that we provide a high quality service and value for money

An improved environment supporting biodiversity, public amenities and recreation

Supporting the community we serve by taking opportunities to support the local economy

Allowed costs/expenditure¹

Wholesale	Water	
Totex – 2015-20 total (£m)	140.7	
Allowed weighted average cost of capital (%)	3.85%	
Allowed wholesale revenue in 2015-20 (£m)	157.1	
Retail	Household	Non-household
Cost allowance – 2015-20 total (£m)	21.2	
Margin (%)	1.00%	2.5%
Retail allowed revenue (£m)	22.7	2.8
Average bill per household customer – retail component only (£)	15	

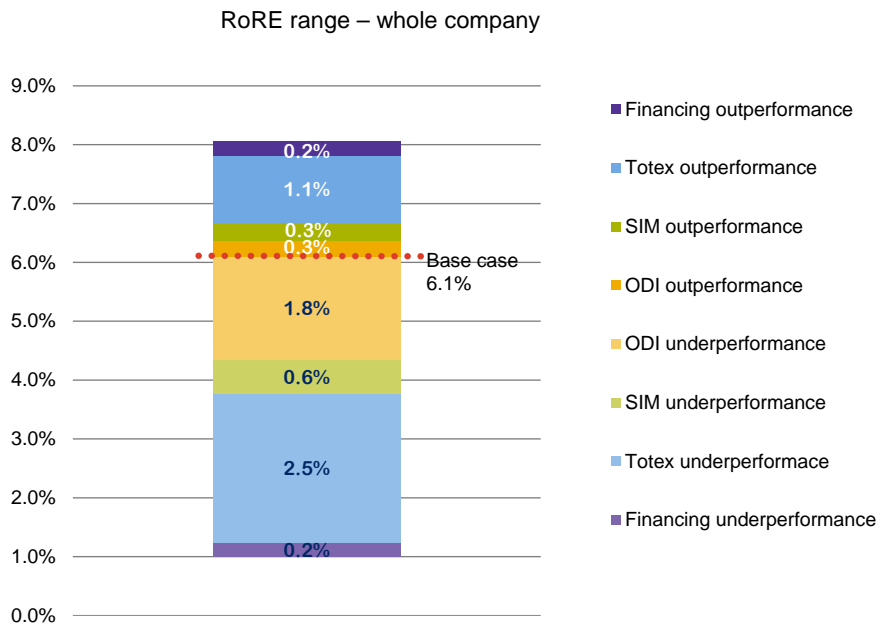
Note:

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

Summary of interventions

Outcomes <ul style="list-style-type: none"> • Cap: We are intending to impose an overall cap and collar on outcome delivery incentives of +/- 2% of RoRE • Horizontal check: We have adjusted one comparable performance commitment level to be more stretching and one reward range to better incentivise over-delivery. • Bottom up analysis: We have adjusted the incentive rates for a number of performance commitments. 	Wholesale Costs <ul style="list-style-type: none"> • We have not intervened in this area
Retail <ul style="list-style-type: none"> • We have rejected the company's adjustment for Input Price Pressure (household). 	Reconciling 2010-15 performance <ul style="list-style-type: none"> • We increased 2010-15 revenue adjustments for wholesale water from £1.6 million to £2.1 million.
Risk and reward <ul style="list-style-type: none"> • We have allowed for a small company uplift of 15 basis points, compared to the company proposed 50 basis points. • We have amended the proposed sharing rate from 80:20 to 75:25 for water business rate risk 	Financeability and Affordability <ul style="list-style-type: none"> • We have reprofiled bills to provide a flat bill profile consistent with the Portsmouth Water business plan.

RoRE ranges – Appointee



Ofwat’s calculations of notional financeability ratios

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Cash interest cover	2.64
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.32
Funds from operations/debt	8.09%
Retained cash flow/debt	5.50%
Gearing	62.11%
Dividend cover (profit after tax/dividends paid)	0.96
Regulatory equity/regulated earnings for the regulated company	16.99
RCV/EBITDA	12.35

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 Portsmouth Water in Table A2.1 below.

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

For some performance commitments and incentive 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	
A safe, secure and reliable supply of drinking water	Asset condition infrastructure bursts	Financial – reward and penalty	Bottom up analysis Increased the incentive rate

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
	Compliance with water quality standards	Financial – penalty	<p>Horizontal check Following review of upper quartile performance, changed the performance commitment in years 3, 4 and 5 to 100% compliance</p> <p>Bottom up analysis Adjusted the incentive rate</p>
	Water quality contacts	Financial – reward and penalty	<p>Bottom up analysis Reintroduce discolouration measure. Adjust the performance commitment level and incentive parameters accordingly</p> <p>Increase the incentive rates.</p>
	Temporary usage bans	Reputational	-
Customers recognise that we provide a high quality service and value for money	Less water lost through leakage	Financial – reward and penalty	<p>Bottom up analysis Increase the incentive rate.</p> <p>Adjust deadbands.</p>

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
	Average minutes of interruptions per property connected	Financial – reward and penalty	Horizontal check Increased reward range by removing reward deadband and cap. Bottom up analysis Increased the incentive rate.
An improved environment supporting biodiversity, public amenities and recreation	Biodiversity improvements	Financial – penalty	Bottom up analysis Increased the incentive rate
	Compliance with Water Framework Directive	Financial – reward and penalty	–
	Carbon	Reputational	–
Proving attractive to investors by providing a long term financially sustainable business	Return on investment	Financial – penalty	–
Recognised by stakeholders as having a culture of health and safety through all our activities	Rospa gold award	Reputational	–

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 annex, we will need to consider the categorisation of the company for assurance purposes at the final determination.

Portsmouth 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](#). Portsmouth water submitted a response to our consultation on our cost models.

In Portsmouth Water's revised business plan the company proposed wholesale water totex of £137 million over 2015-2020 (consistent with the December plan). We calculated the basic cost threshold at £142 million, giving rise to a difference of £5 million or 3%. The company did not make any claims to adjust its threshold.

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 1.8%.

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

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Draft determination cost threshold						141.9
Costs excluded from menu						3.0

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Menu cost baseline ¹	26.8	29.1	29.1	27.6	26.3	138.9
Company's view of menu costs ²						134.1
Implied menu choice						96.5
Allowed expenditure from menu	26.6	28.8	28.8	27.4	26.1	137.7
Costs excluded from menu	0.6	0.6	0.6	0.6	0.6	3.0
Total allowed expenditure ³	27.2	29.4	29.4	28.0	26.7	140.7
Less pension deficit repair allowance	0.0	0.0	0.0	0.0	0.0	0.0
Totex for input to PAYG	27.2	29.4	29.4	28.0	26.7	140.7

Notes:

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

A2.2.2 Calculation of 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 Portsmouth Water wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£m)	27.2	29.4	29.4	28.0	26.7	140.7
PAYG %	79.7%	73.0%	72.1%	75.4%	79.0%	75.9%
Resulting PAYG (£m)	21.7	21.5	21.2	21.1	21.1	106.6

Table A2.4 shows the RCV run-off amounts included within the wholesale water charge. This reflects a run-off rate of 3.8% for the RCV as at 31 March 2015 and 23 years for the totex additions to the RCV over 2015-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Run-off of 2015 RCV	4.6	4.4	4.2	4.1	3.9	21.2
RCV run-off of totex additions	0.1	0.4	0.8	1.1	1.4	3.7
Total RCV run-off	4.7	4.8	5.0	5.2	5.3	24.9

A2.2.3 Return on the RCV

The company has asked for a company specific uplift of 0.50% of the wholesale weighted average cost of capital (WACC) of 3.70% set out in the risk and reward guidance. We have considered whether this it would be appropriate to allow for this uplift based on the approach we set out in our risk and reward guidance:

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

As set out in [risk and reward technical appendix](#), we consider that Portsmouth 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 Portsmouth Water. For the reasons set out in the [risk and reward technical appendix](#), we expect the benefits from providing the company specific uplift to Portsmouth Water would more than offset the costs. This means that the company passed test 2. We expect Portsmouth Water to engage with their customers to provide evidence to demonstrate customer support for the proposed company specific uplift in response to the draft determination.

We have therefore applied a company specific uplift to Portsmouth Water and have used a wholesale water cost of capital of 3.85% in this draft determination. This results in a return on capital of £24.2 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 Portsmouth Water wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	108.4
Land sales	0.0
Adjustment for actual expenditure 2009-10	6.4
Adjustment for actual expenditure 2010-15 ¹	6.1
Net adjustment from logging up, logging down and shortfalls	-0.5
Other adjustments	0.0
Opening RCV 1 April 2015	120.4

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 Portsmouth Water wholesale water return on RCV (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	120.4	121.2	124.4	127.6	129.3
RCV additions (from totex)	5.5	8.0	8.2	6.9	5.6
Less RCV run-off	4.7	4.8	5.0	5.2	5.3
Closing RCV	121.2	124.4	127.6	129.3	129.6
Average RCV (year average)	120.8	122.8	126.0	128.4	129.5
Return on capital	4.7	4.7	4.9	4.9	5.0

A2.2.4 Reconciling 2010-15 performance

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. The company proposed adjustments to the opening RCV and allowed revenue for the wholesale water services to reconcile performance in 2010-15. We have intervened and as a result the revenue adjustments for wholesale water have changed from £1.6 million to £2.1 million. This figure is lower than the mechanisms would have allowed, because the company proposed returning £5.2m to customers. This was a company choice and is not required under our methodology. Consequently, we included this adjustment.

We summarise these interventions and quantify the resulting adjustments within this draft determination in We discuss our interventions in this area further in annex 3.

Table A2.7 below. The impact on the opening RCV of 2010-15 adjustments is - £0.5m as illustrated in Table A2.5 above – this adjustment arises as a result of accepting the company’s proposed logging down claim. We discuss our interventions in this area further in annex 3.

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

Area	Intervention	Why we did it	Total 2010-15
Service incentive mechanism (SIM)	SIM performance penalty has decreased	To reflect updated industry performance in line with the methodology	-0.9
Revenue correction mechanism (RCM)	We have intervened in the following areas. <ul style="list-style-type: none"> • FD09 assumptions. • Outturn financial year average RPI. 	We have concerns regarding FD09 assumptions and data inconsistencies.	9.0
Opex incentive allowance (OIA)	There are no interventions in this area.	n/a	1.6

Area	Intervention	Why we did it	Total 2010-15
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	-2.4
Other adjustments	There are no interventions in this area.	The company proposed returning £5.2m of overall legacy allowance to customers (equivalent to all OIA revenue and the last two years of the RCM). This is the company choice and is not required under our methodology. We will not intervene and have included this adjustment.	-5.2
Total	n/a	n/a	2.1

A2.2.5 Calculation of allowed revenue

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

Overall, we consider that the company's wholesale water revenue allowance should be **£31.0 million** in 2015-16, increasing by **2.6%** to **£31.8 million** in 2019-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex	27.2	29.4	29.4	28.0	26.7	140.7
PAYG ratio	79.71%	72.98%	72.14%	75.42%	79.03%	-
Totex additions to	5.5	8.0	8.2	6.9	5.6	34.1

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
the RCV						
RCV (year average)	120.8	122.8	126.0	128.4	129.5	-
Wholesale allowed revenue build up:						
PAYG ¹	21.7	21.5	21.2	21.1	21.1	106.6
Return on capital	4.7	4.7	4.9	4.9	5.0	24.2
RCV run-off	4.7	4.8	5.0	5.2	5.3	24.9
Tax ²	0.0	0.0	0.0	0.0	0.0	0.0
Income from other sources	-1.3	-1.3	-1.3	-1.3	-1.3	-6.4
Reconciling 2010-15 performance	-0.7	0.6	0.7	0.7	0.7	2.1
Ex-ante additional menu income	0.1	0.1	0.1	0.1	0.1	0.6
Wholesale allowed revenue adjustments						
Profiling adjustments ³	1.0	-0.3	-0.3	-0.3	-0.3	-0.2
Capital contributions from connection charges and revenue from infrastructure charges	0.9	0.9	1.1	1.2	1.2	5.3
Final allowed revenues	31.0	31.1	31.4	31.7	31.8	157.1

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 A5.5.

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 Portsmouth Water’s proposed wholesale water uncertainty mechanisms and our assessment of these proposals.

Table A2.9 Portsmouth Water proposals for wholesale water uncertainty mechanisms

Portsmouth Water proposals	Our assessment
<p>Portsmouth Water proposed an uncertainty mechanism for water business rates with a sharing rate of 80% customer and 20% company.</p>	<p>We consider that the materiality, comparability and control over risk criteria for water business rates are met. The company did not provide evidence to support its proposed sharing rate.</p> <p>We have included a 75%:25% uncertainty mechanism for all companies consistent with our prior guidance and earlier draft determinations. The specific text of this Notified Item and the rationale for its inclusion in the draft determination is set out in the risk and reward technical appendix.</p>

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 Portsmouth Water in Table A3.1 below.

For some performance commitments and incentive 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 retail 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	
Customers recognise that we provide a high quality service and value for money	SIM	Financial – reward and penalty	–
An improved environment supporting biodiversity, public amenities and recreation	Water efficiency	Financial – penalty	Bottom up analysis We amended the performance commitment level
Supporting the community we serve by taking opportunities to support the local economy	Community	Reputational	–

A3.1.1 Outcome delivery and reporting

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

Portsmouth 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 Portsmouth Water’s cost allocation methodology.

Table A3.2 Our assessment of Portsmouth Water’s cost allocation methodology

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

The company has submitted information to suggest that it has allocated most of its costs in line with our guidance. In our draft determination, we have used the company’s cost allocations between retail and wholesale and between household and non-household.

However, we noted the following with respect to the company’s cost allocation.

The company has directly allocated most of its doubtful debt. But £92k relating to a provision for current outstanding debt (£40k) and an allowance for movement in total debt written off (£52k) has not been allocated in accordance with our guidance. The £92k has been allocated on the basis of debt outstanding for greater than 30 days. While the £92k is only a small element of the company’s doubtful debts charge, we consider this could result in a potential material misallocation in the doubtful debts charge between household and non-household based on the thresholds set out in our methodology. The company has not allocated first visits to the customer/investigatory visits between retail and wholesale in line with our guidance.

We have been unable to quantify the impact of this misallocation therefore we cannot confirm that it would not result in a material misallocation between retail and wholesale based on the thresholds set out in our [risk-based review internal methodology](#).

We also note that the company has not obtained any external assurance over its cost allocations, as required by our guidance.

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

- Complete, and submit the findings of, a cross check of the allocation of the £92k doubtful debt charge that has not been directly allocated based on debt written off (that is, how different would the allocation of this £92k be between household and non-household based on debts written off in 2013-14).
- A calculation of what the allocation of first visits to the customer/investigatory visits between retail and wholesale would be in line with our guidance, and in the event that the difference to the current business plan allocation is in excess of our materiality for allocations between retail and wholesale (greater than 2% of R3 line 1 plus R4 line 1) submit a revised table R3 and R4 to us.
- An external assurance report covering the completion of tables R3 and R4 and cost allocations between retail and wholesale and between household and non-household.

A3.2.2 Adjustments

In Table A3.3 below, we outline Portsmouth Water's proposed average cost to serve (ACTS) adjustments and our assessment of these proposals. The adjustments proposed by Portsmouth Water and Ofwat are quantified in Table A3.4. Our approach to assessing adjustment claims is set out in the [household retail technical appendix](#).

Table A3.3 Portsmouth 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	0.6	Pass	Fail	Efficiency benchmarking evidence: Fail	Pass
				Upper quartile: Pass	

Portsmouth Water proposed an adjustment for input price pressure (IPP) of £0.62m over 2015-20.

Ofwat rejects Portsmouth Water's proposal for an ACTS adjustment for input price pressure. Portsmouth Water has not demonstrated that these costs are outside of efficient management control or demonstrated that they are affected in a materially different way to other companies.

The value of the adjustment is material, at 2.8% 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 is limited to some qualitative description of possible measures to mitigate cost increases.

Portsmouth Water provided some limited comparison of relative efficiency outside of the water industry.

Our assessment for ACTS suggests that the company is upper quartile efficient for unmetered household retail costs, but not for metered costs. This assessment is subject to change up to final determination – for example subject to cost allocation changes being made by companies that could affect the ACTS.

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

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Adjustments proposed in Portsmouth Water's business plan						
Input price pressure	0.061	0.092	0.123	0.155	0.187	0.618
Adjustments included in business plan	0.061	0.092	0.123	0.155	0.187	0.618
Adjustments included in draft determination						
Input price pressure	0.000	0.000	0.000	0.000	0.000	0.000
Adjustments included in draft determination	0.000	0.000	0.000	0.000	0.000	0.000

Note:

There will be no indexation for retail price controls.

A3.2.3 New costs

Portsmouth Water did not propose material household retail new costs.

The modification for immaterial new costs included in this draft determination is quantified in Table A3.5.

Table A3.5 New household retail costs (£/customer)

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

Note:

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

A3.3 Calculating the allowed revenues

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

A3.3.1 Net margins

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

Table A3.6 Household retail net margins (%)

	2015-16	2016-17	2017-18	2018-19	2019-20
Household retail net margin	1.00%	1.00%	1.00%	1.00%	1.00%

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

Table A3.7 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	13.87					
Metered water only customers	18.07					
Industry average cost to serve (£/customer)						
Unmetered single service customers						20.73
Metered water only customers						26.78
Allowed cost to serve¹ (£/customer)						
Unmetered single service customers		13.22	13.16	13.09	13.00	12.91
Metered water only customers		17.41	17.36	17.28	17.20	17.11

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Total allowed (£ million)						
Cost to serve (excluding net margin)		4.1	4.2	4.2	4.3	4.3
Forecast household wholesale charge (including forecast RPI ²) ³		33.0	34.2	35.6	36.9	38.2
Household retail revenue (including an allowance for the net margin) ⁴		4	4	5	5	5

Notes:

There will be no indexation for retail price controls.

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

A3.4 Uncertainty mechanisms

We outline our approach to uncertainty mechanisms in the [risk and reward technical appendix](#). In Table A3.8 below, we set out Portsmouth Water's proposed household retail uncertainty mechanisms and our assessment of these proposals.

Table A3.8 Portsmouth Water proposals for household retail uncertainty mechanisms

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

A4. Non-household retail

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

In this chapter, we provide details of Portsmouth 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	0.5	0.5	0.6	0.6	0.6

Note:

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

A4.2 Net margins

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

A4.3 Cost proposals

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

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

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

The company proposed pension deficit repair costs over the control period of zero. This aligned to our forecast.

Overall the company's proposed costs do not increase by more than our non-household retail materiality threshold of 5.3% between 2015 and 2020. We have therefore accepted the company's cost a proposal, that is £1.528 million over the control period.

A5. Appointee

In this section, we discuss at an appointee level:

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

A5.1 Bills and K factors

Table A5.1 below sets out the allowed revenues we have assumed in our draft determination for Portsmouth 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 Portsmouth Water’s draft determination – K factors, allowed revenues and customer bills (in 2012-13 average prices)¹

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water – allowed revenues (£m) ²	31.0	31.1	31.4	31.7	31.8	157.1
Wholesale water – K (%) ³	0.00%	0.38%	0.98%	0.82%	0.13%	-
Retail household allowed revenue (£m)	4.4	4.5	4.5	4.6	4.7	22.7
Retail non-household expected revenue (£m)	0.5	0.5	0.6	0.6	0.6	2.8
Average household bill – water (£) ⁴	92	92	92	92	92	-

Notes:

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

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

A5.2 Uncertainty mechanisms and gain share mechanisms

We outline our approach to uncertainty mechanisms in the [risk and reward technical appendix](#). In table A5.2 below, we set out Portsmouth Water's proposed appointee level uncertainty mechanisms and our assessment of these proposals.

Table A5.2 Portsmouth Water proposals for appointee level uncertainty mechanisms

Portsmouth Water proposals	Our assessment
Portsmouth Water has proposed an uncertainty mechanism for sharing returns in excess of 6% with a sharing rate of 50% customer and 50% company ¹ .	<p>Portsmouth Water can elect to pass on a reduction in bills in future periods due to higher returns in PR14 period without Ofwat's agreement and therefore we do not propose any intervention.</p> <p>However, we note that such a mechanism may not be consistent with incentive based regulation as it may reduce the incentive for Portsmouth Water to seek cost efficiencies and outperform to a level greater than the proposed 6% threshold. The current form of this mechanism could also largely duplicate outperformance shared through the totex</p>

¹ Returns are defined as: (Current cost operating profit – current tax)/average RCV.

Portsmouth Water proposals	Our assessment
	menus. We do not propose PR19 totex reconciliation should take account of gain sharing undertaken by the company.

A5.3 Return on regulated equity range

We set out our approach to calculating the expected range in RoRE in the [risk and reward technical appendix](#). The whole company RoRE range, based on RoRE information provided by Portsmouth, and reflecting our interventions on ODIs, is shown in Table A5.3 below.

Table A5.3 Whole company RoRE range

	Lower bound (%) (appointee)	Upper bound (%) (appointee)
Overall	-5.1%	+2.0%
ODIs	-1.8%	+0.3%
Totex	-2.5%	+1.1%
Financing	-0.2%	+0.2%
SIM	-0.6%	+0.3%

Commentary

The whole company RoRE range is from 1.0% to 8.1%, with a base case of 6.1%, with overall impacts from -5.1% to +2.0%. This range reflects our view of the appropriate small company uplift (see section A2.2.3), rather than Portsmouth's proposed uplift.

The range in totex performance from -2.5% to +1.1% of RoRE has been modelled by Portsmouth Water in reference to the contingency that they use in their normal business planning, which is in turn based on historical cost variation. The totex range is skewed to the downside due to a large proportion of downside risk attributable to a single potential expense that may occur during 2015-20. Portsmouth Water's methodology has been appropriately evidenced and the range equates to -4.3% to +1.9% of totex, which is broadly in line with other companies on the downside and at the lower end of the range on the upside. Given Portsmouth Water's relatively low historic cost variation, the overall range appears reasonable.

The ODI range from -1.8% to +0.3% is based on Portsmouth Water's ODI submissions and our calculated impact of our interventions (see annex 4). The ODI impact on RoRE is skewed to the downside due to larger penalties compared to rewards.

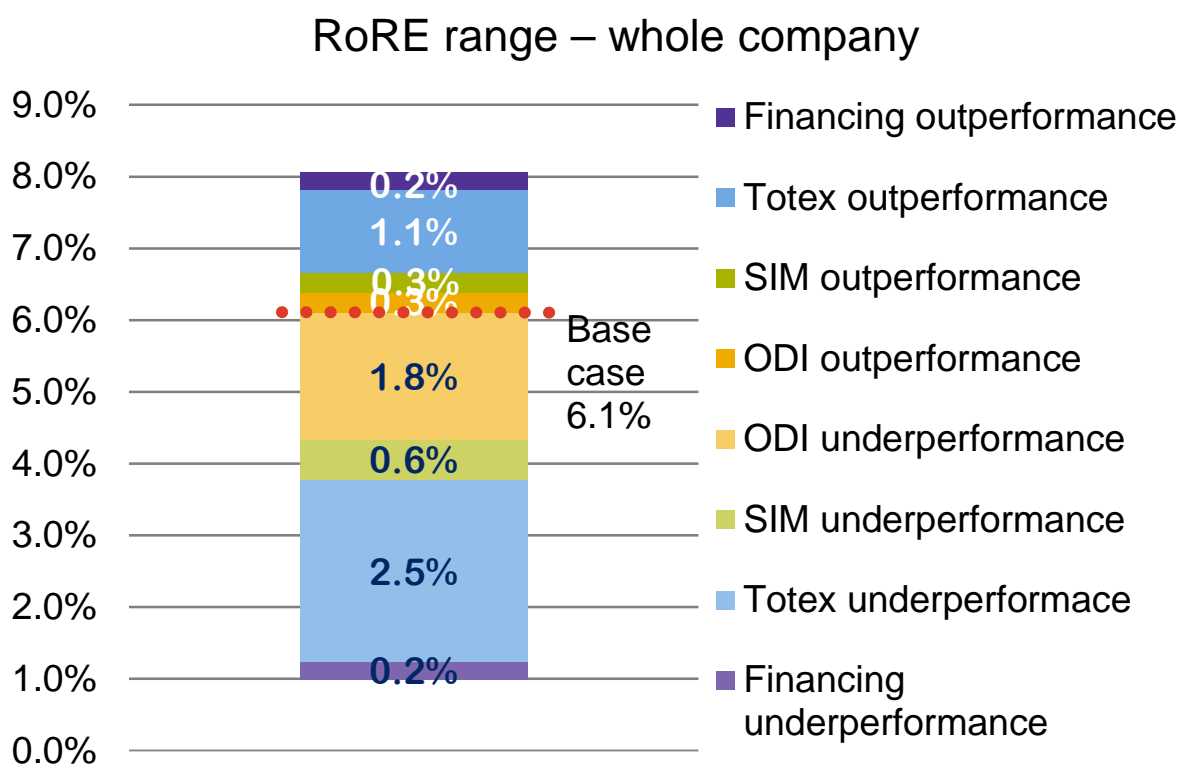
Portsmouth Water has assessed financing impacts (-0.2% to +0.2%) using a scenario of +/-

50 basis points on the cost of new debt. We consider that this is within a plausible range of uncertainty for financing risks and therefore consider it to be acceptable.

Portsmouth Water has estimated SIM impacts using an assumption of maximum rewards and penalties (+0.5% to -1% of revenue). The resulting RoRE impact of approximately -0.6% to +0.3% is acceptable.

The composition of the RoRE range for Portsmouth Water at an appointee level is shown in Figure A5.1 below.

Figure A5.1 Portsmouth Water RoRE range – appointee



Source:

Ofwat calculations based on information from Portsmouth Water.

A5.4 Financeability

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

Table A5.4 Company and Ofwat 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 (ICR)	2.84	2.68	2.64
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.47	1.40	1.32
Funds from operations(FFO)/debt	8.94%	8.56%	8.09%
Retained cash flow/debt	6.40%	5.63%	5.50%
Gearing	60.50%	61.81%	62.11%
Dividend cover (profit after tax/dividends paid)	1.55	1.00	0.96
Regulatory equity/regulated earnings for the regulated company	15.29	15.27	16.99
RCV/EBITDA	11.92	11.83	12.35

Commentary

Financial ratios: Portsmouth Water's current credit rating is BBB with Standard and Poor's and Baa1 with Moody's. It is targeting maintaining this credit rating under its actual and notional structure. The Ofwat calculated ratios for a notional company are slightly lower than Portsmouth Water's calculations. Portsmouth Water has provided Board assurance that it is financeable on an actual and notional basis based on its business plan. However, on an actual company basis Portsmouth Water's interest accretion adjusted FFO/debt ratio would fall below 6%. The interest accretion adjusted FFO/debt ratio is higher on a notional basis due to a lower assumption of index linked debt. We also identified a number of issues in the calculation of company financial ratios, which resulted in a misstatement of ratios in their June business plan.

PAYG changes: Portsmouth Water does not appear to have used PAYG to bring forward revenue as PAYG is set broadly equal to opex+IRE (and around 100% of IRE is expensed).

Pass through of WACC reduction: Under its business plan, Portsmouth Water has retained a 4.2% WACC, broadly consistent with the December plan. We are not proposing

to allow the full level of the company specific uplift that they requested. The draft determination has been based on a wholesale WACC of 3.85% including a company specific uplift of 25bps to the cost of debt. The impact of this reduction in WACC will be passed back to customers in 2015-20.

Conclusion on intervention: On the basis of the notional financial ratios we consider that Portsmouth is financeable and do not intend to intervene. Given the low level of the FFO/debt ratio on an actual basis and the issues identified on financial data that arose during the review of the company’s business plan, Portsmouth Water should provide third party assurance that it is financeable and its calculation of the financial ratio, following the draft determinations. If Portsmouth proposes to adjust PAYG/RCV run off rates in response to the draft determination, they should engage with their customers and demonstrate that the proposed change is in the customers interest. As set out in the technical annex on financeability and affordability, we do not consider that adjustment of PAYG and RCV run off rates is an appropriate response to financeability issues with actual company.

Table A5.5 Sets out the PAYG and RCV run-off rates which show whether revenue has been brought forward compared to the December plan and the impact that this has on RCV growth and longer term affordability and financeability.

Table A5.5 Impact on the longer term

	PAYG rate	RCV run-off	RCV growth % 1 April 2015 to 31 March 2020
Company December plan	75.7%	4.45%	9.0%
Company June plan	75.9%	3.80%	6.8%
draft determinations	75.9%	3.80%	7.7%

A5.5 Affordability

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

Table A5.6 Household bill profile

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Company December plan	91	91	91	91	91	91
Company June plan	91	91	91	91	91	91
Ofwat calculation for June plan	92	91	91	91	91	91
Ofwat calculation for draft determination – pre-reprofiling	92	89	92	92	92	92
Ofwat calculation for draft determinations	92	92	92	92	92	92

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 A5.6) are not directly comparable to the company plans (lines 1 and 2 of Table A5.6). We have reprofiled bills to provide a flat bill profile consistent with the Portsmouth Water business plan by removing the decrease in 2015-16 and subsequent increase in 2016-17.

Table A5.7 sets out the reasons why this draft determination is assessed as affordable. It describes key changes in relation to Portsmouth Water’s December business plan, which we assessed as affordable.

Table A5.7 Business plan affordability assessment

	Commentary
Acceptability	The company passed our risk-based review on affordability. The company conducted customer research to support its original December 2013 business plan submission. Its research found 99% of household customers supported a plan that had an associated bill of £91 in 2019-20 (flat in real terms). It is reasonable to assume that the flat bill profile following our interventions set out in this draft determination will remain acceptable to the majority of the company's customers.
Identification of affordability issues and appropriate support measures	There is no new evidence that the company is planning to alter its original submission's proposals to provide measures to ensure the affordability of its bills in 2015-20. These measures include targeted metering, the introduction of free payments at Post Offices, a debt write off scheme and the company's commitment to work with Southern Water on the development of a social tariff.
Longer-term affordability	The company has explicitly considered future affordability in its consideration of intergenerational equity issues arising from setting PAYG rates and RCV run off. The company has reduced the RCV run off rates from its original submission and proposes to maintain them through to 2025 to avoid upward pressure on bills in the longer term.
Longer-term affordability ODIs	The company's proposals for maximum ODI rewards will not have a negative impact on overall affordability in the longer term as the impact of the maximum reward on bills will be minimal at less than £1. Given the 99% acceptance level of a flat real term bill profile across 2015-20 it is a reasonable assumption that such an impact would still be acceptable to the majority of customers.

Annex 1 Wholesale costs

Establishing draft determination thresholds

Our approach to establishing draft determination thresholds is outlined in the [wholesale water and wastewater technical appendix](#).

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

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

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

Basic cost threshold	Policy additions ¹	Unmodelled costs adjustment	Deep dive ²	draft determination threshold	Deep dives fully or partially not added ³
128.4	12.8	-1.0	1.7	141.9	None

Note:

1. See table AA1.2 below
2. This relates to an adjustment made to companies with no supply demand deficit. The adjustment allows us to introduce an allowance for meter optants into the bottom up modelling stream for companies with no supply demand deficit. As noted in Table AA1.4, Portsmouth Water did not submit any wholesale water cost exclusions therefore no deep dives were undertaken.
3. Deep dives are net of implicit allowances. A value of zero means deep dives are wholly covered by IAs.

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

Business rates	Pension deficit payments	Third party costs	Open market costs ¹	Net v gross adjustments	Total
9.6	0.0	3.0	0.2	0.0	12.8

Note:

1. Of this amount, £0.036 million relates to 2014-15 open market costs.

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

Plan	DD threshold	Gap ¹	Plan v 2010-15
137.0	141.9	-4.9	9.0

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

Company proposal		Assessment				DD allowance	
Claim	Amount sought	Implicit allowance	Need	CBA	Robust costs	Assessment	Amount allowed
Portsmouth Water did not submit any wholesale water cost exclusions, therefore no deep dives were undertaken.							

Annex 2 Household retail revenue modification

We outline our approach to revenue modification in the household retail price control in the [household retail technical appendix](#).

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

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

Revenue modification per:	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only customer	14.12	14.09	14.04	13.97	13.90
Metered water only customer	18.60	18.58	18.54	18.48	18.41

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	207.7	202.7	197.7	192.7	187.7
Metered water only	80.4	87.6	95.1	103.1	111.0

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 Portsmouth 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)	-1.766	-0.870
Revenue correction mechanism (RCM)	9.420	8.977
Opex incentive allowance – post-tax (OIA)	1.584	1.585
Capital expenditure incentive scheme (CIS)	-2.410	-2.397
Tax refinancing benefit clawback	0.000	0.000
Other tax adjustments	0.000	0.000
Equity injection clawback	0.000	0.000
Other adjustments	-5.224	-5.224
Total wholesale legacy adjustments	1.604	2.070

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](#).

Table AA3.2 provides the annualised rewards from the company's SIM performance. The differences in views reflect differences in the application of the methodology. The company view reflects that their predicted comparative performance was the lowest in the industry. The Ofwat view uses up to date industry performance data and reflects that the company comparative performance is better than the company predicted.

Table AA3.2 SIM annualised rewards (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-0.35	-0.351	-0.353	-0.355	-0.357	-1.766
Ofwat view	-0.174	-0.174	-0.174	-0.174	-0.174	-0.870

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 Portsmouth Water's proposed 2010-15 RCM adjustments.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	1.884	1.884	1.884	1.884	1.884	9.420
Ofwat view	1.795	1.795	1.795	1.795	1.795	8.977

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

Area of intervention	What we did	Why we did it
FD09 assumptions	Our assumptions for the draft determination reflect our view of the FD09 assumptions.	There are inconsistencies between the company's and our view of the FD09 assumptions used in the company's populated RCM model.
Out-turn financial year average RPI	We use the out-turn financial year average RPI data that the company submitted in business plan table A9 to calculate our view of the RCM adjustment for the draft determination.	There are inconsistencies with the out-turn financial year average RPI between table A9 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 AA3.4 summarises our interventions in relation to Portsmouth 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	1.458	0.114	0.012	0.000	0.000	1.584
	Ofwat view	0.317	0.317	0.317	0.317	0.317	1.585

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

Area of intervention	What we did	Why we did it
Profiling of the post-tax allowance.	We spread the post-tax incentive allowance evenly over the 2015-20 period.	In line with the approach the company set out in its early engagement submission commentary, where the company used even phasing to ensure customer bills remain flat.

Change protocol (logging up, logging down and shortfalls)

Table AA3.7 and Table AA3.8 below summarise Portsmouth 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 Portsmouth Water’s proposed change protocol adjustments.

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

2009-10 to 2014-15 – post-efficiency capex	Company view	Ofwat view
Logging up (two sided)	0.000	0.000
Logging down (two sided)	-0.460	-0.460
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 to ensure customers are not required to pay for the regulatory output the company has failed to deliver.

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

2009-10 to 2014-15 – post-efficiency opex	Company view	Ofwat view
Logging up	0.000	0.000
Logging down	-0.046	-0.046
Shortfalls	0.000	0.000
Shortfalls for serviceability	0.000	0.000

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

Area of intervention	What we did	Why we did it
Optional Meters – Logging down	There are no interventions for this scheme. We are accepting the company’s proposed logging down claim	n/a

Service standard outputs

The final determination supplementary reports in 2009 contained defined project(s) where the primary output was the service standard specified². 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.

² In the final determination supplementary reports we said: “Both the project activity (as proposed in your final business plan) and the service standard are the defined output. You must demonstrate delivery of the stated service standard output through the June return. The service standard output is the primary output. We recognise that companies may decide to prioritise activity differently in order to achieve the service output in a more efficient manner. All material changes to the project activity must be reported and explained through your June return.”

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

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

Serviceability performance

Table AA3.10 below summarises our serviceability assessments for Portsmouth 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 Portsmouth Water’s proposed adjustments for serviceability.

Table AA3.10 Serviceability assessments for 2010-15¹

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

Notes:

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

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

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

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

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

The 2009 agreed overlap programme

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

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

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

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

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

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	108.577
	Ofwat view	108.566
Out-turn CIS ratio	Company view	123.344
	Ofwat view	123.211
Incentive reward/penalty (%)	Company view	-6.176
	Ofwat view	-6.144
Reward/penalty (£m)	Company view	-2.392
	Ofwat view	-2.382
Adjustments to 2015-20 revenue (£m)	Company view	-2.242
	Ofwat view	-2.232
CIS adjustment to RCV (£m)	Company view	5.593
	Ofwat view	5.593
Commentary		
The company has applied the published Ofwat methodology. However, we identified minor discrepancies between the RPI financial year average values in the company's populated CIS feeder model and table A9. We have thus used values in table A9 in our CIS model.		

Water service

In carrying out our assessment we have 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	-0.482	-0.482	-0.482	-0.482	-0.482	-2.408
Ofwat view	-0.479	-0.479	-0.479	-0.479	-0.479	-2.397

Notes:**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	-5.224	-5.224	The company proposed returning £5.2m of overall legacy allowance to customers (equivalent to all OIA revenue and the last two years of the RCM). This is the company choice and is not required under our methodology. We will not intervene and have included this adjustment.

Annex 4 Outcomes, performance commitments and outcome delivery incentives

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

The two figures below first provide an overview of these 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 AA4.2 shows the potential financial impact of each of the financial incentives.

Figure AA4.1 The composition of the package of ODIs

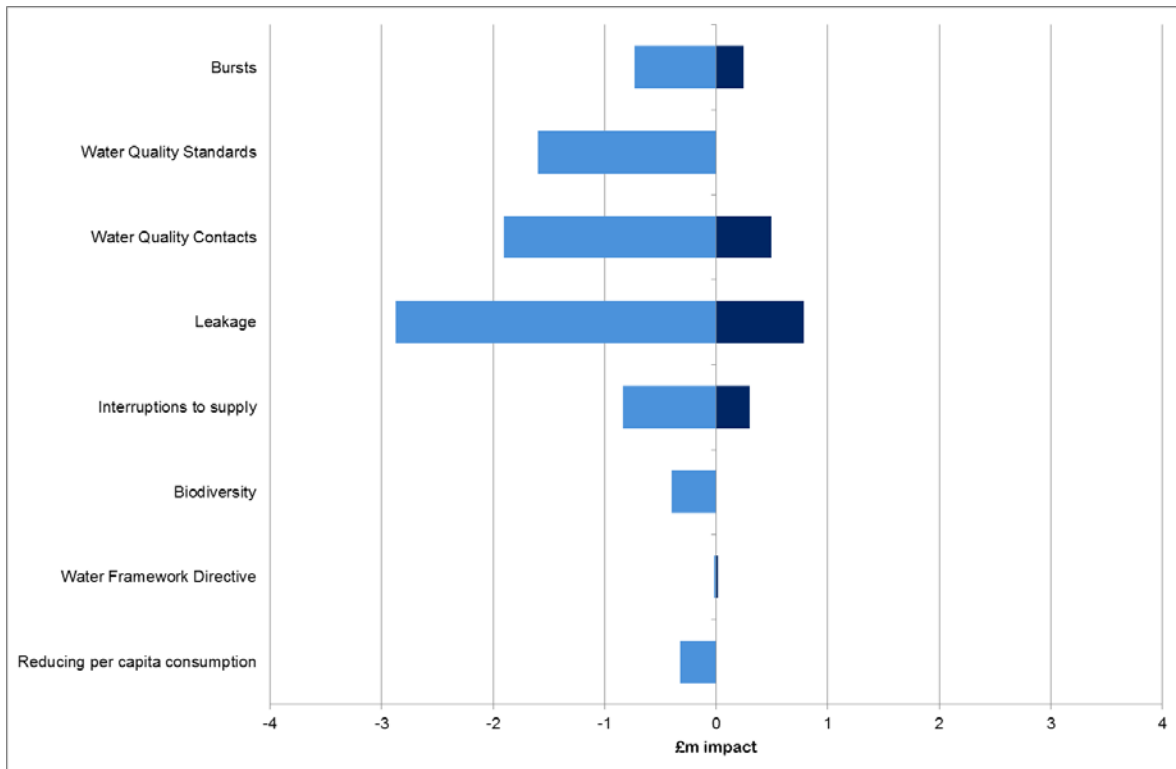
	Reward and penalty	Penalty only	Non-financial incentive
Wholesale water	5	3	3
Household retail	1	1	1
Total	6	4	4

The following graph shows the potential financial consequences of the individual financial ODIs over the five years. The figures represent the penalties and rewards associated with the p10 and p90 scenarios respectively. This means there is a 10% chance of performance being higher or lower than these assumed levels. In Portsmouth Water's case it has capped rewards and penalties at these levels so they also represent the maximum penalties and rewards. We have not included Portsmouth Water's gain share mechanism (Performance commitment F1: Return on investment) in the graph.

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 the [outcomes technical appendix](#).

There are no specific exclusions from the cap/collar for Portsmouth Water.

Figure AA4.2 Overview of financial ODIs



Tables AA4.2 and AA4.3 set out a more detailed explanation of our interventions in the company's wholesale water and 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
All financial incentives	Adjusted incentive rates to align with time period for assessment (that is, average performance over 2015-20)	<p>Insufficient customer protection</p> <p>Portsmouth Water has proposed to assess performance annually and then apply incentives based on average performance over 2015-20. However, incentive rates were determined using one year’s annualised costs and WTP. It was therefore necessary to intervene on either the incentive rate or application of incentive.</p> <p>We decided that it was more appropriate to intervene on the incentive rate rather than the PC to retain company ownership. However, we are concerned that Portsmouth Water has not sufficiently engaged with customers as to whether annual incentives or year 5 average incentives are more appropriate. Furthermore, it has not explained how it would deal with situations where it delivers the average performance but the performance in 2019-20 which best represents long-term performance is below the PC level.</p> <p>We would therefore expect Portsmouth Water to provide improved evidence to explain its approach and ensure incentive rates and assessment period align.</p>
A1: Asset condition – infrastructure (mains bursts)	<p>Multiplied the incentive rates by 5, such that incentive rates are now:</p> <p>Penalty = £4,457/burst</p> <p>Reward = £1,642/burst</p>	<p>Insufficient customer protection</p> <p>Portsmouth Water proposes that the PC is assessed at the end of the next price control period, 2015-20, based on the five-year average result, but the ODI rates are estimated using one year’s annualised cost and WTP.</p> <p>Where Portsmouth Water over- or under-delivers by 1 burst on</p>

PC/ODI affected	What we did	Why we did it
		<p>average over the five years it represents five bursts in total. Applying one year’s annualised incentive rate would therefore not fully compensate customers or reward the company. We therefore multiply the incentive rates by 5 to align these with Portsmouth Water’s approach to determining the extent of the incentive to be applied.</p>
<p>A3: Compliance with water quality standards</p>	<p>Changed the performance commitment level in years 3, 4 and 5 to 100% compliance</p>	<p>Horizontal consistency check</p> <p>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. No change is required to Portsmouth Water’s penalty deadband as it is already set at greater than 99.96%.</p> <p>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.</p>
<p>A3: Compliance with water quality standards</p>	<p>Adjust incentive rate into an annual figure, such that the incentive rate is now:</p>	<p>Insufficient customer protection</p> <p>Portsmouth Water proposes that the PC is assessed at the end of the next price control period, 2015-20, based on the five-year average</p>

PC/ODI affected	What we did	Why we did it
	<p>Penalty = £319,420/year</p>	<p>result but the ODI rates are estimated using one year's annualised cost and WTP. The ODI penalty is based on a pass/fail approach whereby the full penalty applies if performance is below 99.97%.</p> <p>Where Portsmouth Water under-delivers by 0.01% on average over the five years it represents 0.01%/year. However, because the penalty is based on a pass/fail approach it is not appropriate to simply multiply the incentive rate by 5. Instead we have intervened such that if Portsmouth Water fails to meet the deadband on average, the size of the incentive will be based on the number of years where Portsmouth Water failed to deliver at least 99.97%, with the annual incentive applying for each year of failure.</p>
<p>A4: Water quality – reduce the number of contacts the company receives regarding quality of water supplied</p>	<p>Reintroduced discolouration and illness to the measure</p> <p>Adjusted the PC level to reflect the inclusion of discoloration and illness, such that the level reduces from 0.434 in 2014-15 to 0.413 in 2019-20. Caps and collars also increase relative to the PC level</p> <p>Changed the measurement basis to an average over 2015-20 and multiplied penalty and reward rates to reflect a five-year average measurement, such that</p>	<p>Insufficient customer protection</p> <p>Portsmouth Water proposed only to focus on taste and odour, with no separate discoloration measure proposed. With the removal of Portsmouth Water's serviceability measures from the December plan we are concerned whether Portsmouth Water's set of measures fully protects the long-term interests of customers. We have therefore added discolouration contacts back into this measure as an indicator of asset health.</p> <p>In addition, Portsmouth Water proposes that the PC is assessed only against performance in 2019-20. Water Quality Contacts is a direct measure of customer impact that is more appropriate for annual assessment rather than a long-term target so we have changed to a five-year average assessment to align with other measures. We therefore also multiply the incentive rate by 5 to align the incentive</p>

PC/ODI affected	What we did	Why we did it
	incentive rates are now: Penalty = £226,550/0.01 contacts per 1,000 population Reward = £58,855/0.01 contacts per 1,000 population	rate with the assessment of performance.
B1: Reported Leakage Level	Multiplied the incentive rates by 5, such that incentive rates are now: Penalty = £871,210/MI/d Reward = £61,060/MI/d Adjusted deadbands	<p>Insufficient customer protection</p> <p>Portsmouth Water proposes that the PC is assessed at the end of the next price control period, 2015-20, based on the five- year average result, but the ODI rates are estimated using one year’s annualised cost and WTP.</p> <p>Where Portsmouth Water over- or under-delivers by 1 MI/d on average over the 5 years it represents 5 MI/d in total. Applying one year’s annualised incentive rate would therefore not fully compensate customers or reward the company. We therefore multiply the incentive rates by 5 to align these with Portsmouth Water’s approach to determining the extent of the incentive to be applied.</p> <p>Portsmouth Water proposed flat reward and penalty deadbands at average annual performance. However, because PRT is targeting a reduction over the price control period, 2015-20, we have aligned the deadbands with the annual PC levels to reflect this reduction.</p>
C1: Average minutes of interruptions per property connected	Multiplied the incentive rates by 5, such that incentive rates are now: Penalty = £418,660/minute	<p>Insufficient customer protection/Horizontal consistency check</p> <p>Portsmouth Water proposes that the PC is assessed at the end of the next price control period based on the five- year average result, but the ODI rates are estimated using one year’s annualised cost and</p>

PC/ODI affected	What we did	Why we did it
	<p>Reward = £60,435/minute</p> <p>Removed the reward deadband and cap following horizontal check.</p>	<p>WTP.</p> <p>Where Portsmouth Water over- or under-delivers by 1 minute on average over the five years it represents five minutes in total. Applying one year’s annualised incentive rate would therefore not fully compensate customers or reward the company. We therefore multiply the incentive rates by 5 to align these with Portsmouth Water’s approach to determining the extent of the incentive to be applied.</p> <p>Despite Portsmouth Water providing leading performance in the area of interruptions the potential for Portsmouth Water to earn reward is limited. Following our horizontal checks we therefore have increased the reward range by removing the reward deadband and cap to increase the potential for Portsmouth Water to earn reward and bring it more in line with the approaches put forward by other leading performers. Even with these changes the maximum penalty still exceeds the maximum reward due to the asymmetric incentive rates.</p>
D1: Biodiversity	<p>Multiplied the incentive rate by 5, such that incentive rate is now:</p> <p>Penalty = £44,095/10% not delivered</p>	<p>Insufficient customer protection</p> <p>Portsmouth Water proposes that the PC is assessed only against performance in 2019-20. This is appropriate as it is a measure of performance over the five years. However, the ODI rates are estimated using one year’s annualised cost and WTP.</p> <p>Where Portsmouth Water under-delivers by 10% by 2019-20 customers need to be compensated for the full loss associated with this under-delivery. Applying one year’s annualised incentive rate would therefore not fully compensate customers or reward the company. We therefore multiply the incentive rates by 5 to align these</p>

PC/ODI affected	What we did	Why we did it
		with Portsmouth Water’s approach to determining the extent of the incentive to be applied.

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

PC/ODI affected	What we did	Why we did it
B1: Reducing per capita consumption	We have amended the performance commitment levels associated with determining incentives to align with the commitments in table R1	<p>Insufficient customer protection</p> <p>The PC levels in table R2 are insufficiently stretching. We therefore use the figures supplied by Portsmouth Water in table R1, which do represent appropriate improvements</p>

Outcome delivery and reporting

In the [outcomes technical appendix](#), we outline a framework against which we have assessed Portsmouth Water’s proposals in relation to outcome delivery and reporting.

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

Table AA4.4 Portsmouth Water’s proposals for outcome delivery and reporting

Portsmouth Water proposals	Our assessment
<p>Portsmouth Water sets out full details of its approach to outcome delivery and reporting in section 5 of ‘Response to Ofwat’s Risk and Reward Guidance and Risk-based review’. These can be summarised as follows.</p> <p>CCG involvement: CCG will review performance against performance commitments, with sub-groups created for specific interest areas.</p> <p>Measurement and data capture: processes already in place for data capture against all PCs. Individuals responsible for reporting against company/industry methodologies</p> <p>Audit and assurance: use existing Risk and Compliance Statement process with existing auditors to financially and technically review performance reports, with Board having ultimate responsibility for assurance.</p> <p>Governance and accountability: Risk and Compliance Statement to be reviewed by CCG, supported by technical auditor</p> <p>Transparency and publication: Risk and Compliance Statement will be published on the company website and included in subsequent customer communications</p>	<p>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.</p> <p>Portsmouth 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.</p> <p>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.</p>

In the remainder of this section, we provide the following information on each performance commitment that 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 applicable³; and
 - the incentive rates.
- Additional details on the measure.
- Where Ofwat has not accepted the company's proposals, the nature of the intervention made is also explained.

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

We have intervened in relation to a number of performance commitments proposed by the company. Where we have amended the company's proposed incentive but retained the performance commitment, we have intentionally set out our interventions below using a ~~strike through~~. 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).

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

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

Wholesale water outcome: Safe secure and reliable drinking water

Performance commitment A1: Bursts

Detailed definition of performance measure: Bursts on the network are a measure of its serviceability. The definition is that provided by Ofwat BP3121.

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
Performance Commitment	No.	342	342	342	342	342	342
Penalty collar			600	600	600	600	600
Penalty deadband			435	435	435	435	435
Reward deadband			250	250	250	250	250
Reward cap			100	100	100	100	100

Incentive rates

Incentive type	Performance levels (no.)		Incentive rate (£/burst)
	Lower	Upper	
Penalty	435	600	£4,457 £894
Reward	250	100	£1,642 £328

Additional details

Necessary detail on measurement units	Bursts; this is as defined by Ofwat – Reference BP3121
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC on average over the period.
Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period
Form of reward/penalty	Adjustment to revenue in AMP7
Any other information or clarifications relevant to correct application of incentive	None

Performance commitment A3: Water quality standards

Detailed definition of performance measure: Water quality standards as measured by mean zonal compliance. This is the average of the compliance rates (at a zonal level) for the 39 parameters tested and reported to the Drinking Water Inspectorate to demonstrate compliance.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
			2014-15	2015-16	2016-17	2017-18	2018-19
Performance Commitment	%	99.98	99.98	99.98	100 99.98	100 99.98	100 99.98
Penalty collar			n/a	n/a	n/a	n/a	n/a
Penalty deadband	%		99.97	99.97	99.97	99.97	99.97

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£/year)
	Lower	Upper	
Penalty	n/a	99.97	£319,420

Additional details

Necessary detail on measurement units	The unit is percentage compliance with standards on a calendar year basis.
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC on average over the period. Incentive determined by the number of years where performance drops below the penalty deadband.
Timing and frequency of rewards/penalties	Penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	This ODI is determined through a two-step process. Firstly, average annual performance will determine whether a penalty should apply. Secondly, if required, the size of the penalty will be determined by the number of years where performance dropped below the penalty deadband. None

Performance commitment A4: Water quality contacts

Detailed definition of performance measure: A measure of customer contact for ~~taste and odour~~ taste, odour, discolouration and illness calculated as the number of contacts per 1,000 population measured on a calendar year basis. This is reported annually to the Drinking Water Inspectorate.

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
Commitment	Nr/1000 pop	0.434 0.220	0.429 0.218	0.425 0.216	0.421 0.214	0.417 0.212	0.413 0.210
Penalty collar	Nr/1000 pop		0.505 0.250	0.505 0.250	0.505 0.250	0.505 0.250	0.505 0.250
Penalty deadband	Nr/1000 pop		0.429 0.218	0.425 0.216	0.421 0.214	0.417 0.212	0.413 0.210
Reward deadband	Nr/1000 pop		0.429 0.218	0.425 0.216	0.421 0.214	0.417 0.212	0.413 0.210
Reward cap	Nr/1000 pop		0.337 0.170	0.337 0.170	0.337 0.170	0.337 0.170	0.337 0.170

Incentive rates

Incentive type	Performance levels (nr/1000 population)		Incentive rate (£/0.01 per 1,000)
	Lower	Upper	
Penalty	0.421	0.505	£226,550
	0.21	0.25	£45,310
Reward	0.421	0.337	£58,855
	0.21	0.17	£11,771

Additional details

Necessary detail on measurement units	The number of customers contacting the company relating to the taste and odour taste, odour, discolouration and illness on a calendar year basis.
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC on average over the period.

Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period
Form of reward/penalty	Adjustment to revenue in AMP7
Any other Information or clarifications relevant to correct application of incentive	None

Performance commitment A5: Temporary usage bans

Detailed definition of performance measure: Introduction of water restrictions in the period in accordance with our approved drought plan.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance Commitment	No./ year	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	The number of water restrictions in place on customers in the report year. 'Water restriction' refers to any application of use or availability restrictions as per the Portsmouth Water Drought Plan.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported at the end of each financial year
Any other information or clarifications relevant to correct application of incentive	None

Wholesale water outcome: High quality service

Performance commitment B1: Leakage

Detailed definition of performance measure: The total level of leakage, including customer supply pipe leakage, as measured on an average MI/d basis; this is as defined by Ofwat – Reference BN2345

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
Performance Commitment	MI/d	30.0	30.00	29.95	29.90	29.85	29.80
Penalty collar	MI/d		33.2	33.2	33.2	33.2	33.2
Penalty deadband	MI/d		30.0 29.9	29.95 29.9	29.9	29.85 29.9	29.80 29.9
Reward deadband	MI/d		30.0 29.9	29.95 29.9	29.9	29.85 29.9	29.80 29.9
Reward cap	MI/d		17.0	17.0	17.0	17.0	17.0

Incentive rates

Incentive type	Performance levels (MI/d)		Incentive rate (£/MI/d/year)
	Lower	Upper	
Penalty	>29.9	33.2	871,210 174,242
Reward	17.0	<29.9	61,060 12,212

Additional details

Necessary detail on measurement units	Leakage as measured on an average MI/d basis; this is as defined by Ofwat – Reference BN2345
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC of 29.9MI/d on average over the period.
Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	None.

Performance commitment C1: Interruptions to supply

Detailed definition of performance measure: Average time of supply interruption per property within the Portsmouth supply area (includes both planned and unplanned interruptions) as defined for the Ofwat KPI in IN13/03.

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
Performance Commitment	Min	5 mins 0 s	5 m 0 s	5 m 0 s	5 m 0 s	5 m 0 s	5 m 0 s
Penalty collar	Min		8 m 0 s	8 m 0 s	8 m 0 s	8 m 0 s	8 m 0 s
Penalty deadband	Min		6 m 0 s	6 m 0 s	6 m 0 s	6 m 0 s	6 m 0 s
Reward deadband	Min		5 m 0 s	5 m 0 s	5 m 0 s	5 m 0 s	5 m 0 s
			4 m 0 s	4 m 0 s	4 m 0 s	4 m 0 s	4 m 0 s

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Reward cap	Min		n/a 2 m 0 s	n/a 2 m 0 s	n/a 2 m 0 s	n/a 2 m 0 s	n/a 2 m 0 s

Incentive rates

Incentive type	Performance levels		Incentive rate (£ / minute)
	Lower	Upper	
Penalty	6 mins	8 mins	£418,660
			£83,732
Reward	0 mins	5 mins	£60,435
	4 mins	2 mins	£12,087

Additional details

Necessary detail on measurement units	Average time of supply interruption per property within the Portsmouth supply area (includes both planned and unplanned interruptions) as defined for the Ofwat KPI in IN13/03.
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC on average over the period.
Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	The incentive rate is set out as £/minute. However, the size of the incentive will be determined to the second and the relevant proportion of the incentive will apply.

Wholesale water outcome: An improved environment supporting biodiversity

Performance commitment D1: Biodiversity

Detailed definition of performance measure: The company will agree its Biodiversity Action Plan with the relevant stakeholders including its customer challenge group (CCG) and incur a penalty if it does not complete 90% of the agreed actions.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance Commitment	%	n/a	0	25	50	75	90
Penalty collar			0	0	0	0	0
Penalty deadband			n/a	n/a	n/a	n/a	n/a

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£ / 10%)
	Lower	Upper	
Penalty	0	90	£44,095 £8,819

Additional details

Necessary detail on measurement units	The measurement is against the agreed plan.
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Frequency of PC measurement and any use of averaging	Performance will be measured annually. However, the commitment is to achieve 90% of the agreed plan by the end of the AMP period and this will determine whether an incentive should apply.
Timing and frequency of rewards/penalties	Penalties will apply at the end of the period
Form of reward/penalty	Adjustment to revenue in AMP7
Any other information or clarifications relevant to correct application of incentive	None

Performance commitment D2: Water Framework Directive

Detailed definition of performance measure: Obligations under Water Framework Directive are required to be complete by 2021. The company commits to deliver by 2017-18, with a penalty for later delivery and a reward for earlier delivery.

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
Performance Commitment					Target Date		
Penalty collar							Delivered
Penalty deadband							
Reward deadband							
Reward cap			Delivered				

Incentive rates

Incentive type	Performance levels		Incentive rate (£ / annum)
	Lower	Upper	
Penalty	2018-19	2019-20	£9,838 per year later than PC
Reward	2015-16	2016-17	£7,152 per year earlier than PC

Additional details

Necessary detail on measurement units	Completion of the programme, signed off by EA.
Frequency of PC measurement and any use of averaging	At the point of project completion, or the end of the AMP period, whichever is sooner.
Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	None.

Performance commitment D3: Carbon

Detailed definition of performance measure: The company will increase the amount of electricity it uses from renewable sources by 10% by the end of the period.

Incentive type: Reputational.

Performance commitments

	Starting level	Committed performance levels

	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance Commitment	% increase	0	2	4	6	8	10

Additional details

Necessary detail on measurement units	The company will report on its performance annually.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported at the end of each financial year.
Any other information or clarifications relevant to correct application of incentive	None.

Wholesale water outcome: Attractive to investors

Performance commitment F1: Return on investment

Detailed definition of performance measure: Where the rate of return is greater than 6% (as defined by the return on the regulatory capital value) there will be a 50:50 sharing with customers.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
			2014-15	2015-16	2016-17	2017-18	2018-19
Performance Commitment	%		To be determined				
Penalty collar							
Penalty deadband			6%	6%	6%	6%	6%
			<6%	<6%	<6%	<6%	<6%

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (sharing / year)
	Lower	Upper	
Penalty			50%

Additional details

Necessary detail on measurement units	The unit is percentage return on the RCV.
Frequency of PC measurement and any use of averaging	Performance will be measured annually. Commitment is to achieve the PC on average over the period.
Timing and frequency of rewards/penalties	Penalties will apply at the end of the period.

Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	The Company will share financial out-performance, as measured by the return on the capital value above 6%.

We set out our view on gain share mechanisms in section A5.2.

Wholesale water outcome: Health and safety culture

Performance commitment G1: RoSPA

Detailed definition of performance measure: The company will apply for its Health and Safety accreditation annually.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance Commitment		awarded	awarded	awarded	awarded	awarded	awarded

Additional details

Necessary detail on measurement units	Outcome of the RoSPA assessment.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported at the end of each financial year.
Any other information or clarifications relevant to correct application of incentive	None.

Retail outcome: High quality service

Performance commitment A1: Service Incentive Mechanism

Detailed definition of performance measure: SIM score as defined in Ofwat's SIM guidance and updated in IN13/03.

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
Performance Commitment	Industry score	Upper quartile	Upper quartile				
Penalty collar			Ofwat methodology				
Penalty deadband			Ofwat methodology				
Reward deadband			Ofwat methodology				
Reward cap			Ofwat methodology				

Incentive rates

Incentive type	Performance levels		Incentive rate
	Lower	Upper	
Penalty			Ofwat methodology
Reward			Ofwat methodology

Additional details

Necessary detail on measurement units	All companies report and Ofwat publish an annual industry SIM score.
Frequency of PC measurement and any	Performance will be measured annually

use of averaging	through the Risk and Compliance Statement.
Timing and frequency of rewards/penalties	Rewards and penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	None.

Retail outcome: An improved environment supporting biodiversity

Performance commitment B1: Reducing per capita consumption

Detailed definition of performance measure: The company will report its weighted average household per capita consumption annually. Definitions will be as per Ofwat guidance in the water balance, table 10. Weightings will relate to the measured and unmeasured property counts

Incentive type: Financial – penalty – only applying only at year 5.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	l/h/d	147.29	146.63 148	145.96 147	145.29 146	144.61 145	143.93 144
Penalty collar	l/h/d						148
Penalty deadband							

Incentive rates

Incentive type	Performance levels (l/h/d)		Incentive rate (£ / l/h/d)
	Lower	Upper	
Penalty	143.93 144	148	£81,244

Additional details

Necessary detail on measurement units	The measurement is against the agreed PC target by year 5.
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Frequency of PC measurement and any use of averaging	Performance will be measured annually but the incentive will be determined based on performance in 2019-20 only.
Timing and frequency of rewards/penalties	Penalties will apply at the end of the period.
Form of reward/penalty	Adjustment to revenue in AMP7.
Any other information or clarifications relevant to correct application of incentive	None.

Retail outcome: Supporting the community

Performance commitment C1: Survey of developers

Detailed definition of performance measure: The company will develop a satisfaction survey relating to the service delivered to developers.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance Commitment	survey	-	70%	70%	70%	70%	70%

Additional details

Necessary detail on measurement units	Survey to be established and agreed with stakeholders (including CCG) in Q3 and Q4 2014-15.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported at the end of each financial year.
Any other information or clarifications relevant to correct application of incentive	None.

Table AA4.1 Performance commitments proposed by the company that we have removed from this draft determination

Performance commitment	Reason for its removal
Wholesale water	
None.	
Household retail	
None	

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



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