

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



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Overview

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

South East Water has not revised its plan substantially from what it submitted in December. It did however choose to give further evidence in support of the issues that were identified as part of the risk-based review. We have needed to intervene in a number of areas in the plan. These interventions include disallowing a number of claims for wholesale costs, rejecting the company's claim for a specific uplift to the cost of capital and adjustments to reflect performance between 2010 and 2015. There are further interventions in the plan designed to safeguard customers' interests in common with other companies around outcomes and the associated delivery incentives.

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 South East Water, along with what they mean for average customer bills. We have summarised this information in the 'draft determinations at a glance section'. The draft determination also sets out:

- the outcomes we expect the company to deliver under each price control;
- the costs we are assuming the company will incur and, where appropriate, the assumptions we have made to arrive at the allowed revenue for each price control;
- the adjustments we are making to the wholesale water controls 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.

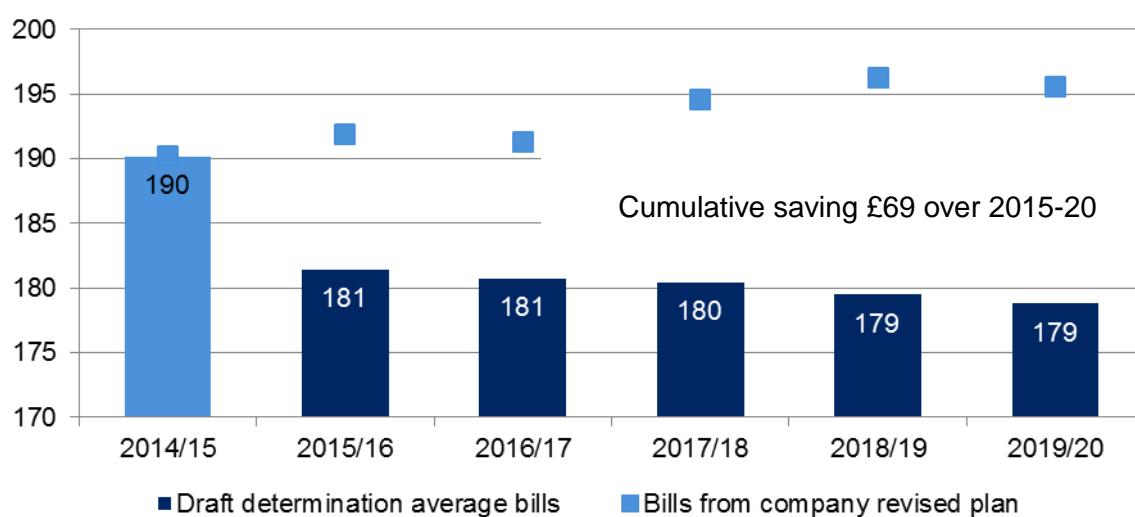
Annexes 1 to 4 form part of the draft price control determination.

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

Customers consider the appearance of their water to be acceptable

Customers consider the frequency and duration of supply interruptions is acceptable

Customers consider the frequency of water use restrictions to be acceptable

We are compliant with water quality regulations

We are compliant with environmental obligations

We are compliant with health and safety regulations

We are compliant with National Security obligations

We are compliant with other statutory obligations and licence conditions

Our assets are capable of delivering outcomes in the future

We will reduce our impact on the environment

Retail

- Customers consider the level of leakage to be acceptable
- Customers consider their direct interaction experience to be acceptable
- Customers consider bills to be value for money and affordable
- Customers consider their water supply is of sufficient pressure
- Customers consider the frequency and duration of supply interruptions is acceptable
- Customers consider the frequency of water use restrictions to be acceptable

Allowed costs/expenditure¹

Wholesale	Water	
Totex – 2015-20 total (£m)	768.3	
Allowed weighted average cost of capital (%)	3.7%	
Allowed wholesale revenue in 2015-20 (£m)	886.6	
Retail	Household	Non-household
Cost allowance – 2015-20 total (£m)	96.8	
Margin (%)	1.0%	2.5%
Retail allowed revenue (£m)	105.6	17.3
Average bill per household customer – retail component only (£)	25	

Notes:

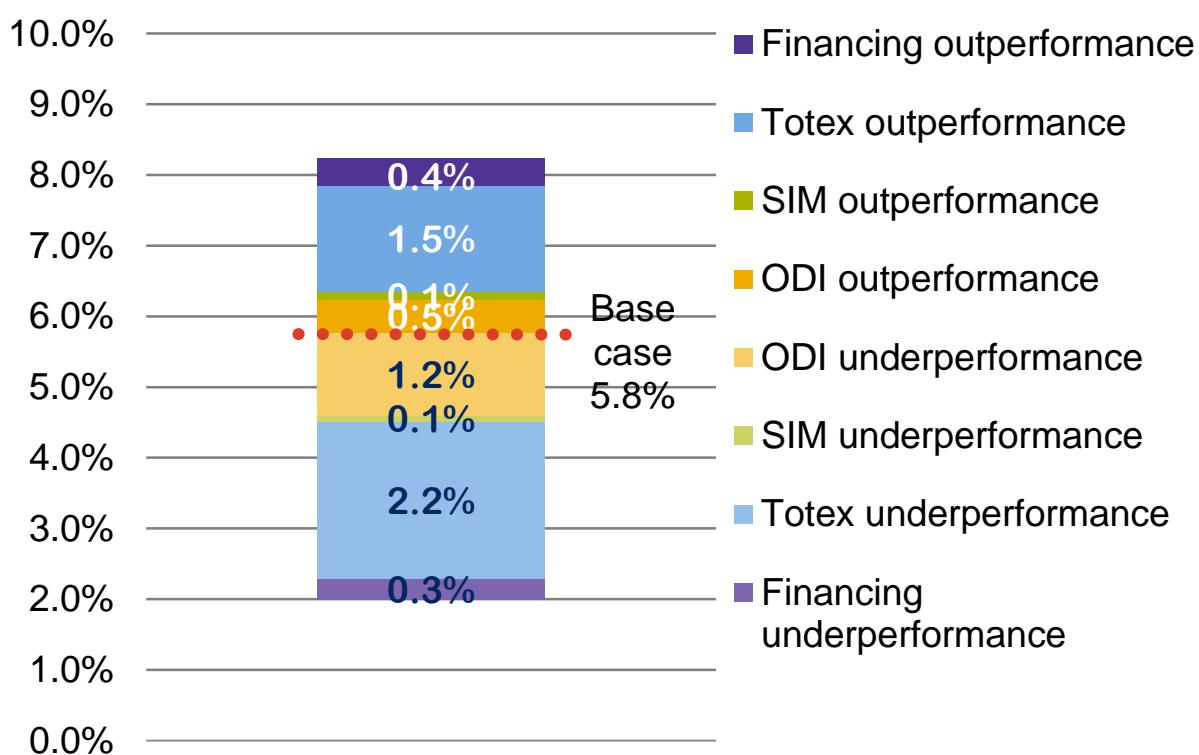
¹Wholesale figures in 2012-13 prices and retail figures in nominal prices – this is consistent throughout this draft determination unless otherwise stated.

Summary of interventions

Outcomes	Wholesale costs
<ul style="list-style-type: none"> • Cap: We have imposed an overall cap and collar on outcome delivery incentives of +/- 2% of RoRE • Horizontal check: We have adjusted the performance level for one performance commitment, adjusted penalty collar for another and have added a penalty for a third. • Bottom-up analysis: We removed the reward for three performance measures and have adjusted a number of incentives to increase the range of reduced performance over which penalties apply 	<ul style="list-style-type: none"> • The company proposed wholesale water totex of £810 million in its plan which is £36 million above our draft determination threshold of £774 million • We partially accepted one of the company's proposed wholesale cost adjustments, but have rejected the others

<p>Retail</p> <ul style="list-style-type: none"> We have rejected the company's proposed adjustment for input price pressure 	<p>Reconciling 2010-15 performance</p> <ul style="list-style-type: none"> We have increased the scale of the adjustments related to 2010-15 performance which has reduced the revenue requirement by £6 million We applied a shortfall on water infrastructure serviceability for poor performance on interruptions which has resulted in a downwards RCV adjustment of £17 million
<p>Risk and reward</p> <ul style="list-style-type: none"> We have rejected the company's proposed company specific uplift We have removed the pain/gain mechanism to share the interest costs of new bonds 	<p>Financeability and affordability</p> <ul style="list-style-type: none"> We have reprofiled bills

RoRE ranges – appointee



Ofwat's calculations of notional financeability ratios

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Cash interest cover	2.88
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.73
Funds from operations/debt	8.86%
Retained cash flow/debt	6.28%
Gearing	62.93%
Dividend cover (profit after tax/dividends paid)	1.09
Regulatory equity/regulated earnings for the regulated company	17.42
RCV/EBITDA	11.40

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

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

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Customers consider the appearance of their water to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
Customers consider the taste and odour of their water to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Customers consider the level of leakage to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	No intervention
	Leakage target	Financial – reward and penalty	Horizontal check: We have adjusted the penalty collar to make it consistent with other companies
Customers consider their direct interaction experience to be positive	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
	Service incentive mechanism (SIM)	Financial – reward and penalty	No intervention
Customers consider their bills to be value for money and affordable	Survey of customer satisfaction	Reputational incentive	No intervention
Customers consider the water supply is of sufficient pressure	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
	Properties at risk of low pressure	Reputational incentive	No intervention
Customers consider the frequency and duration of supply interruptions is	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
acceptable	Average time lost per property	Financial – reward and penalty	Horizontal check: We have adjusted the performance commitment so that by 2017 -18 it reflects current upper quartile performance and we have adjusted penalty collars to maintain the company's proposed maximum penalty
Customers consider the frequency of water use restrictions to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
	Security of Supply Index	Financial – reward and penalty	Bottom-up analysis: We have removed the reward as it was not sufficiently justified
We are compliant with water quality regulations	Mean Zonal Compliance	Reputational incentive	Horizontal check: We have added a financial penalty to protect customers
We are compliant with environmental obligations	Number of breaches of abstraction licences, discharge consents and environmental permits	Reputational incentive	No intervention
	Pollution incidents (category 1-2)	Reputational incentive	No intervention

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
We are compliant with health and safety regulations	Number of compliance breaches of legislation	Reputational incentive	No intervention
We are compliant with National Security obligations	Number of breaches	Reputational incentive	No intervention
We are compliant with other statutory obligations and licence conditions	Number of compliance breaches	Reputational incentive	No intervention
Our assets are capable of delivering outcomes in the future	Below ground asset performance assessment (infrastructure)	Financial – reward and penalty	Bottom-up analysis: We have removed the reward as it was not sufficiently justified
	Above ground asset performance assessment (non-infrastructure)	Financial – reward and penalty	Bottom-up analysis: We have removed the reward as it was not sufficiently justified
	Number of sites at risk of flooding	Reputational incentive	No intervention
We will reduce our impact on the environment	Kg of carbon emissions per customer per year	Reputational incentive	No intervention
	We will monitor our abstractions at low flows at environmentally sensitive sites	Reputational incentive	No intervention

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.

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

A2.2 Calculating the wholesale water price control

A2.2.1 Calculating allowed wholesale water expenditure

Our approach to calculating allowed wholesale expenditure is set out in the [wholesale water and wastewater technical appendix](#).

In South East Water's revised plan the company proposed wholesale water totex of £810m over 2015-2020. We calculated the draft determination threshold at £774 million, giving rise to a difference of £36 million or 4.7%. We did consider making a further £16 million in adjustments to our threshold (net of implicit allowances), however the company did not provide sufficient evidence to support these claims. We also note that the company made representations to our cost models following the publication of these in April. The representations made and our response is summarised in [wholesale water and wastewater technical appendix](#).

The actual gap faced by the company against our totex threshold is smaller than that implied by the gap. This is because the use of menus and our approach to setting baselines reduces the difference faced by the company. The difference between the company's plan and the amount it would ultimately recover from customers is only 2.3%.

The proposed wholesale water allowed expenditure for South East 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						773.6
Costs excluded from menu						14.2
Menu cost baseline ¹	144.6	152.4	161.8	155.4	145.1	759.4
Company's view of menu costs ²						794.5
Implied menu choice						104.6
Allowed expenditure from menu	146.3	154.2	163.7	157.2	146.8	768.2
Costs excluded from menu	2.9	2.8	2.8	2.8	2.8	14.2
Total allowed expenditure ³	149.2	157.0	166.5	160.1	149.6	782.4
Less pension deficit repair allowance	2.8	2.8	2.8	2.8	2.8	14.1
Totex for input to PAYG	146.4	154.2	163.7	157.2	146.8	768.3

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 South East Water wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£m)	146.4	154.2	163.7	157.2	146.8	768.3
PAYG %	60.6%	57.2%	55.8%	59.4%	63.7%	59.4%
Resulting PAYG (£m)	88.7	88.2	91.4	93.5	93.5	455.3

Table A2.4 shows the RCV run-off amounts included within the wholesale water charge. This reflects a run-off rate of 3.49% for the RCV as at 31 March 2015 and 50 years for the totex additions to the RCV over 2015-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Run-off of 2015 RCV	37.0	35.8	34.5	33.3	32.1	172.7
RCV run-off of totex additions	0.6	1.8	3.2	4.6	5.7	15.9
Total RCV run-off	37.6	37.6	37.7	37.9	37.9	188.6

A2.2.3 Return on the RCV

The company has asked for a company specific uplift of 0.36% of the wholesale weighted average cost of capital (WACC) of 3.70% set out in the risk and reward guidance. We have considered whether it would be appropriate to allow for this uplift based on the approach we set out in our risk and reward guidance.

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

As set out in the [risk and reward technical appendix](#), based on advice from PwC we do not consider that South East Water as a large water only company faces a higher cost of finance. This means that South East Water failed test 1 higher cost of finance and we did not go on to consider test 2 of offsetting benefits to customers. We are therefore intervening in South East waters business plan to set a wholesale water cost of capital of 3.70% in this draft determination. This results in a return on capital of £208.2 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 South East Water wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	1,069.9
Land sales	-2.5
Adjustment for actual expenditure 2009-10	3.9
Adjustment for actual expenditure 2010-15 ¹	7.5
Net adjustment from logging up, logging down and shortfalls	-17.3
Other adjustments	0.0
Opening RCV 1 April 2015	1,061.5

Note:

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

Table A2.6 South East Water wholesale water return on RCV (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	1061.5	1081.6	1110.0	1144.6	1170.5
RCV additions (from totex)	57.7	66.0	72.3	63.8	53.3
Less RCV run-off	37.6	37.6	37.7	37.9	37.9
Closing RCV	1081.6	1110.0	1144.6	1170.5	1185.9
Average RCV (year average)	1071.5	1095.8	1127.3	1157.5	1178.2
Return on capital	39.6	40.5	41.7	42.8	43.6

A2.2.4 Reconciling 2010-15 performance

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 reduced 2010-15 revenue adjustments for wholesale water from £11.9 million to £6.3

million. We summarise these interventions in table A2.7 below. The impact on the opening RCV of 2010-15 adjustments is shown in Table A2.5 above. As noted in the table, we have applied -£17.3m in (net) adjustments arising from logging up, logging down and shortfalls. We have intervened and applied a shortfall of -£17.3m – this relates to supply interruptions. Further information on our interventions and rationale is set out in annex 3.

Table A2.7 South East 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 increased	To reflect updated industry performance in line with the methodology	-7.2
Revenue correction mechanism (RCM)	We have intervened in the following areas: <ul style="list-style-type: none"> • Back billing • PR14 discount rate • Household revenues • FD09 assumptions • Number of households billed 	We have concerns as to whether the back billing amounts being claimed put forward by the company are compliant with RAG4.04 and IN11/04 and so have disallowed these claims. We also have more minor concerns on FD09 assumptions, data inconsistencies and the application of discount rates that are detailed further in annex 3.	20.1
Opex incentive allowance (OIA)	There are no interventions in this area.	N/A	3.7
Capital expenditure incentive scheme (CIS)	Our assumption of the discount rate for the draft determination is 3.70%. We used this value when profiling the revenue adjustment	The company has broadly applied the published Ofwat methodology. However the company used its submitted uplifted cost of capital of 4.06% as the discount rate when profiling the revenue adjustment.	-8.2

Area	Intervention	Why we did it	Total 2010-15
Other adjustments			-2.1
Total	n/a	n/a	6.3

A2.2.5 Calculation of allowed revenue

We set out the calculation of the allowed revenue for South East Water's wholesale water control in table 2.8.

Overall, we consider that the company's wholesale water revenue allowance should be £176.2 million in 2015-16, increasing by 1.2% to £178.4 million in 2019-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex	146.4	154.2	163.7	157.2	146.8	768.3
PAYG ratio	60.57%	57.20%	55.83%	59.45%	63.72%	-
Totex additions to the RCV	57.7	66.0	72.3	63.8	53.3	313.0
RCV (year average)	1071.5	1095.8	1127.3	1157.5	1178.2	-
Wholesale allowed revenue build up:						
PAYG ¹	91.5	91.0	94.2	96.3	96.4	469.4
Return on capital	39.6	40.5	41.7	42.8	43.6	208.2
RCV run-off	37.6	37.6	37.7	37.9	37.9	188.6
Tax ²	1.9	1.1	0.3	0.4	0.4	4.1
Income from other sources	-0.5	-0.5	-0.5	-0.5	-0.5	-2.7
Reconciling 2010-15 performance	2.5	0.9	0.9	0.9	0.9	6.3
Ex ante additional menu	-0.9	-0.9	-1.0	-0.9	-0.9	-4.5

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
income						
Wholesale allowed revenue adjustments						
Profiling adjustments ³	1.0	3.6	0.4	-2.6	-3.0	-0.6
Capital contributions from connection charges and revenue from infrastructure charges	3.5	3.5	3.6	3.6	3.6	17.8
Final allowed revenues	176.2	176.8	177.3	177.8	178.4	886.6

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 South East Water's proposed wholesale water uncertainty mechanisms and our assessment of these proposals.

Table A2.9 South East Water proposals for wholesale water uncertainty mechanisms

South East Water proposals	Our assessment
South East Water proposed an uncertainty mechanism for water business rates with a sharing rate of 75% customer and 25% company	We consider that the materiality, comparability and control over risk criteria for water business rates are met. 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 .

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 South East Water in table A3.1 below.

For some performance commitments and incentives types, we have intervened to change the underlying performance level or incentives. These interventions are listed in table A3.1 below. Full detail of the household 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 consider the appearance of their water to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
Customers consider the taste and odour of their water to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
Customers consider the level of leakage to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	No intervention

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Customers consider their direct interaction experience to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
	SIM	Financial – reward and penalty	No intervention
Customers consider bills to be value for money and affordable	Survey of customer satisfaction	Reputational incentive	No intervention
Customers consider their water supply is of sufficient pressure	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
Customers consider the frequency and duration of supply interruptions is acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies
Customers consider the frequency of water use restrictions to be acceptable	Survey of customer satisfaction	Financial – reward and penalty	Bottom-up analysis: We have increased the range over which a penalty applies

A3.1.1 Outcome delivery and reporting

In the [assurance technical appendix](#), we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015 -2020 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the

opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself

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

South East 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

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.

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 South East Water's cost allocation methodology.

Table A3.2 Our assessment of South East Water's cost allocation methodology

Area assessed	Assessment
No potential material misallocations	Pass
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 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 note that the company has not obtained any external assurance over its cost allocations, as required by our guidance and that the company has prepared its retail tables on the basis of Generally Accepted Accounting Practice in the UK (UK GAAP) rather than International Financial Reporting Standards (IFRS).

We expect the company to submit the following information to us with its draft determination representations, by 3 October at the latest:

- 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; and
- business plan tables R3 and R4 completed on an IFRS basis

A3.2.2 Adjustments

In table A3.3 below, we outline South East Water's proposed average cost to serve (ACTS) adjustments and our assessment of these proposals. The adjustments proposed by South East 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 South East 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	9.5	Pass	Fail	Efficiency benchmarking evidence: Fail	Pass
				Upper quartile: Fail	

South East Water proposed an adjustment for input price pressure (IPP) for £9.5m over 2015-20.

We reject South East Water's proposal for an ACTS adjustment for input price pressure. South East Water has not shown that these costs are outside of efficient management control or demonstrated that it is affected in a materially different way to other companies.

The value of the adjustment is material, at 8.4% of household retail operating expenditure plus depreciation over 2015-20.

Overall the evidence provided on management practices is not sufficient and does not convince us that the company manages its costs to the extent that future cost increases are outside of efficient management control. We do however consider that the evidence on management practices around wages is sufficient.

The evidence provided on relative efficiency includes benchmarking of wages against salaries outside the water industry. We do not consider this to be sufficient evidence to demonstrate that South East Water is an efficient retailer compared to companies outside of the water industry.

Because of our assessment of their relative efficiency the company has not demonstrated that they are affected in a materially different way to the average company. Our assessment for ACTS suggests that the company is not upper quartile efficient for unmetered or metered household retail 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 South East Water, for completeness we have assessed the evidence provided on the size of an adjustment. The size of the adjustment is calculated bottom up from relevant inflation rates for appropriate cost areas. 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 South East Water's business plan						
Input price pressure	1.143	1.428	1.777	2.290	2.817	9.453
Pension deficit repair costs	0.646	0.646	0.646	0.646	0.646	3.230
Adjustments included in business plan	1.789	2.074	2.423	2.936	3.463	12.683

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Adjustments proposed in South East Water's business plan						
Adjustments included in draft determination						
Input price pressure	0.000	0.000	0.000	0.000	0.000	0.000
Pension deficit repair costs	0.598	0.598	0.598	0.598	0.598	2.991
Adjustments included in draft determination	0.598	0.598	0.598	0.598	0.598	2.991

Note:

There will be no indexation for retail price controls.

A3.2.3 New costs

South East Water did not propose material household retail new costs.

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	19.75					
Metered water only customers	26.61					
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		17.05	17.37	17.70	17.93	18.18
Metered water only customers		23.71	23.83	23.95	23.99	24.24
Total allowed (£ million)						
Cost to serve (excluding net margin)		18.2	18.8	19.4	19.9	20.5
Forecast household wholesale charge (including forecast RPI ²) ³		189.3	196.3	203.7	211.1	218.2
Household retail revenue (including an allowance for the net margin) ⁴		19.9	20.5	21.2	21.7	22.4

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 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 South East Water's proposed household retail uncertainty mechanisms and our assessment of these proposals.

Table A3.8 South East Water proposals for household retail uncertainty mechanisms

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

A4. Non-household retail

In the [non-household retail technical appendix](#), we outline our overall approach to the non-household retail price control. Further information regarding our observations on companies' proposals for their non-household retail price controls is set out in Information Note 14 – 2014 price review – non-household customer engagement ahead of draft determination representations. In this chapter, we provide details of South East 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	3.4	3.4	3.5	3.5	3.5

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. This resulted in the company’s proposals being adjusted from £0.570 million over the control period, to £0.479 million.

The company included an allowance for input price pressures. This figure was not accompanied by supporting evidence in the non-household retail control. No evidence was provided as to why the net margin was insufficient for covering input price risks. While the company did provide evidence for an input price pressure allowance in the household retail control, this evidence did not pass our criteria on the quality of supporting evidence and was deemed insufficient. Consequently, we have not added an input price pressure element to the company’s non-household retail control. We have therefore adjusted the company’s proposals by £1.670 million over the control period to reflect this.

In total, this resulted in the company’s proposed costs being adjusted from £12.587 million over the control period to £10.826 million.

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 South East 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 South East 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	176.2	176.8	177.3	177.8	178.4	886.6
Wholesale water – K (%) ³	0.00%	0.32%	0.40%	0.11%	0.11%	-
Retail household allowed revenue (£m)	19.9	20.5	21.2	21.7	22.4	105.6
Retail non-household expected revenue (£m)	3.4	3.4	3.5	3.5	3.5	17.3
Average household bill – water (£) ⁴	181	181	180	179	179	-

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 South East Water's household and non-household customer base. In practice, this will depend upon the structure of wholesale charges implemented by South East Water.

We note that customer bills in the regulatory period from 2020 will be affected by South East 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 and gain share mechanisms

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

Table A5.2 South East Water's proposals for appointee level uncertainty and gain share mechanisms

South East Water proposals	Our assessment
<p>South East Water has proposed a pain/gain sharing mechanism which would share, on a 50:50 basis, the interest costs variation on new debt (new bonds issued during the period 2015-20) from its planning assumption for the cost of new debt. This is akin to a debt indexation scheme that would provide the company some protection in the case of higher costs of new debt</p>	<p>We have rejected the mechanism as it transfers risk to customer around changes in interest rates. As set out in our methodology statement, we consider that the debt indexation and pain/gain sharing approaches on the cost of debt are not in customers' interests as companies are best placed to manage financing risk</p> <p>Materiality: Fail The financing scenarios presented by South East Water indicate that the P10/P90 impacts represent only 0.2% of total revenue and so we do not consider the impact is material</p> <p>Controllability: Fail Companies are responsible for their own capital structures and are able to exercise significant control</p>

South East Water proposals	Our assessment
	<p>over financing costs. They are best placed to manage financing risks</p> <p>Comparability with other companies: Fail South East Water is the only company to have proposed such a scheme, even though the risks would be similar across companies. South East Water has not provided sufficient evidence to justify why it requires specific protection</p> <p>Customer protection: Fail We consider that South East Water's customers should not bear risks that are not borne by customers of other water companies</p>

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 South East Water, 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	-3.8%	+2.4%
ODIs	-1.2%	+0.5%
Totex	-2.2%	+1.5%
Financing	-0.3%	+0.4%
SIM	-0.1%	+0.1%

Commentary:

The whole company RoRE range is from 2.0% to 8.2%, with a base case of 5.8%. This translates to a downside impact of -3.8% and an upside variance of +2.4% as shown in the table.

Cost performance variance has been modelled by South East Water using a comprehensive set of Ofwat specified and company specific scenarios supported by robust evidence. The

resultant RoRE impacts, ranging from -2.2% to +1.5%, are skewed to the downside because of specific cost risks, particularly relating to pensions. The range is consistent with other companies.

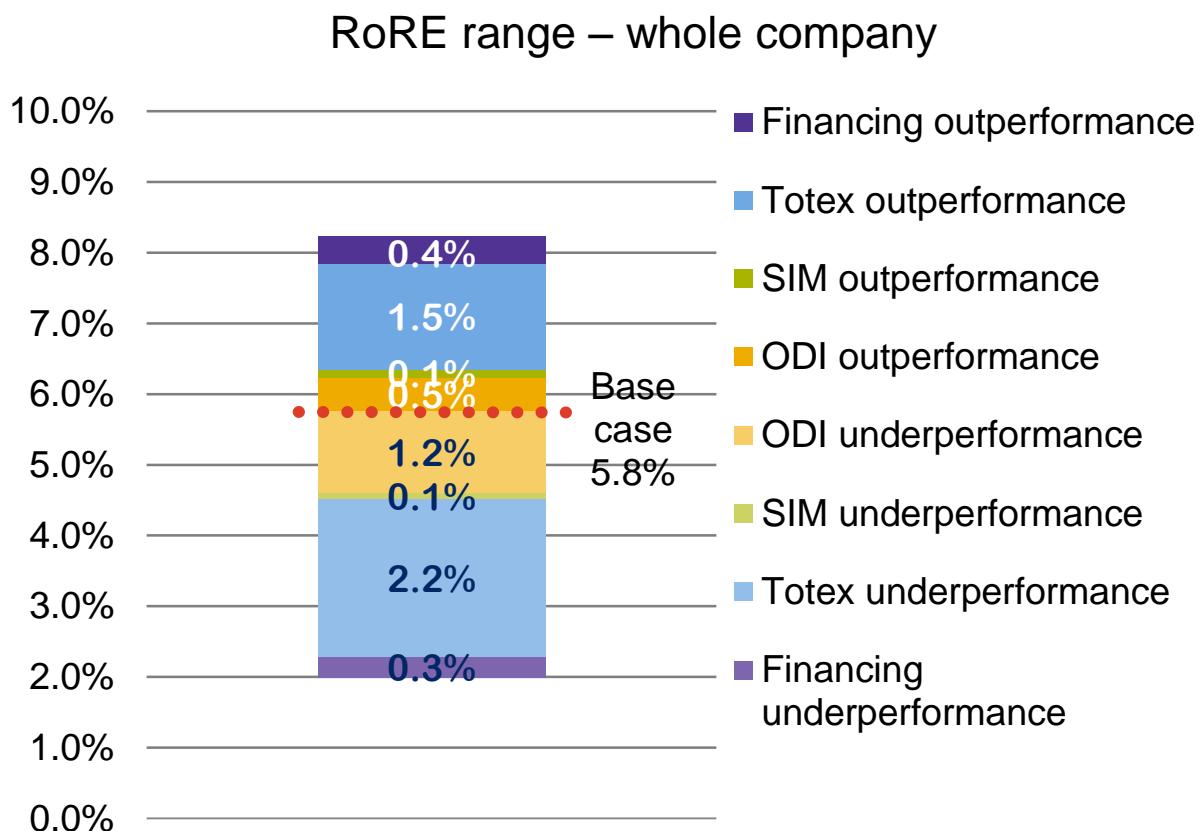
The ODI range proposed by South East Water was from -1.0% to +1.0%. We have adjusted this range to -1.2% to +0.5% to take account of our interventions discussed in annex 4.

South East Water, based on advice from Frontier Economics, provided upside and downside scenarios equivalent to a variation of -24 and +17 basis points on all debt, which translates to a RoRE range of -0.3% to +0.4%. We consider this to be reasonable.

The SIM range has been assessed using a narrower range than the maximum possible which reflects South East Water's aspirations and commitment to improving customer service. Based on the company's initiatives in this area, South East Water considers that the downside risk will not exceed the upside and a risk range of +0.1% represents a reasonable downside scenario. We accept the company's rationale.

The composition of the RoRE range for South East Water at an appointee level is shown in figure A5.1 below.

Figure A5.1 South East Water RoRE range – appointee



Source:

Ofwat calculations based on information from South East Water

A5.4 Financeability

We have compared the financial ratios provided by South East Water and our calculation of its financial ratios implied by the company's business plan proposals submitted on 27 June 2014, 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 notional financial ratio calculations based on the company business plan and notional 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)	2.63	2.75	2.88
Adjusted cash interest cover ratio (ACICR) – base case (average over five years)	1.63	1.71	1.73
Funds from operations (FFO)/debt	8.40%	8.99%	8.86%
Retained cash flow/debt	6.19%	6.29%	6.28%
Gearing	63.17%	63.50%	62.93%
Dividend cover (profit after tax/dividends paid)	1.01	1.15	1.09
Regulatory equity/regulated earnings for the regulated company	15.81	16.18	17.42
RCV/EBITDA	10.92	10.80	11.40

Commentary:

Financial ratios: South East Water is targeting a credit rating of BBB and has provided Board assurance based on an actual and notional capital structure. Our calculated financial ratios for the company's business plan are slightly above South East Water, with similar financial ratios for our draft determinations. We therefore consider that South East Water is financeable on a notional basis.

Use of PAYG: South East Water has maintained PAYG rates at around 60% from the December plan with PAYG equivalent to Opex plus IRE, although South East Water is only expensing 50% of IRE and so PAYG is 116% of IRE expensed. The company has increased RCV run-off by 0.3% and so has passed through around 60% of the reduction in the WACC (4.44% to 4.06%) in lower customer bills in 2015-20.

Conclusion on intervention: While the company has increased revenue in 2015-20 through the use of RCV run-off, its financial ratios are consistent with its target credit rating and we are not intending to provide a company specific uplift on the WACC. We are therefore not intervening with regard to financeability. If the company wishes to adjust its PAYG or RCV run off rates in response to the draft determination, we would expect them to engage with their customers and demonstrate the changes were in customers' interests.

Table A5.5 sets out the PAYG and RCV run-off rates which shows whether these rates have been adjusted compared to the December plan and the impact that this has on RCV growth and longer term affordability and financeability. The company has slightly reduced PAYG rate and increased RCV run off.

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	60.4%	3.26%	13.8%
Company June plan	59.4%	3.49%	13.0%
Draft determination	59.4%	3.49%	11.7%

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 determinations.

Table A5.6 Household bill profile

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Company December plan	195	191	191	194	196	195
Company June plan	195	189	188	191	191	190
Ofwat calculation for June plan	190	192	191	195	196	196
Ofwat calculation for draft determinations	190	181	181	180	179	179

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 and 4 of table A5.6) are not directly comparable to the company plans (lines 1 and 2 of table A5.6). Our interventions have reduced revenue and bill requirements over 2015-20. In the absence of customer preferences for bill profiles at this level we have reprofiled bills so that there is a large reduction in the first year with broadly flat bills for the remainder of the period. This equalises the customer benefits across the period. We invite South East Water to engage with its customers on their priorities for bills as part of its response to the draft determinations.

Table A5.7 Business plan affordability assessment

	Commentary
Acceptability	In its December plan, South East Water's customer engagement found that 86% of customers considered its proposals to be acceptable. In the risk-based review recommendation, we fed back that we were not convinced the impact of the Thames Tideway Tunnel (TTT) had been effectively incorporated into the company's research. South East Water re-ran its research for the June submission, taking our comments into account, and found that acceptability of its plan was now measured at 77% for Thames sewerage customers – who in like for like terms recorded 82% acceptability in the original research. However, only 49% found the plan acceptable when it includes the sewage component and the impact of TTT has been explained. We accept that this is an accurate representation of customer views.

	Commentary
Identification of affordability issues and appropriate support measures	<p>In its December submission South East Water outlined the comprehensive set of existing measures it has in place to help customers with affordability problems, which include: the Water Sure tariff, water direct, flexible payment plans, write-off scheme, water efficiency advice/audits, 3rd party debt advice, and a metering programme with a phase-in tariff. An additional measure proposed in the plan is the introduction of a new social tariff that will provide a discount on bills of up to 40% for around 15,000 customers by 2020.</p> <p>The company also acknowledges that the findings of the re-run acceptability research highlight issues around the impact of TTT on affordability which it plans to deal with by undertaking a customer communications programme collaboratively with Thames Water. In light of this and the proposed introduction of social tariff, we consider that the company has identified the relevant issues and support measures.</p>
Longer-term affordability – cost recovery tools	<p>In its December plan, South East Water demonstrated that it had consulted with future customers in some elements of its customer engagement programme, and there was no evidence that its choice of PAYG and RCV run-off ratios would negatively impact either current or future customers. In the revised plan, South East Water has made only minor changes to its PAYG and RCV run-off ratios and states that it has not changed its underlying approach to setting cost recovery ratios.</p>
Longer-term affordability – ODIs	<p>The company provided sufficient evidence that it has revisited its package of ODI measures in accordance with the new guidance.</p> <p>The company supported its ODI work with a new piece of customer research which found that: 60% of customers support the principle of linking water bills to company performance, and 78% of customers support the maximum reward package and the associated bill increase of £5. The research also found that most customers would prefer the bill impacts to take effect 'in-period'.</p> <p>The CCG gives broad support of the revised work the company has undertaken on ODIs.</p>

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	Draft determination threshold	Deep dives fully or partially not added ²
698.6	82.7	-8.0	0.3	773.6	16.5

Notes:

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

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

Business rates	Pension deficit payments	Third party costs	Open market costs ¹	Net v gross adjustments	Total
67.8	14.1	0.0	0.8	0.0	82.7

Note:

1. Of this amount, £0.122m 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
809.7	773.6	36.1	50.7

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
Regional network/ Zonal strategies ¹	£52.9m	£36.4m	Fail	Fail	Partial Pass	Reject	£0.0m
Water resource management plans ²	£17.4m	£5.8m	Pass	Pass	NA	Partially accept	£11.6m
Abnormal ground water treatment	£8.8m	£8.8m	NA	NA	NA	Reject	£0.0m
Overlap Adjustment ³	£0.3m	£0.0m	NA	NA	NA	Accept	£0.3m

Note:

1. In its June submission the company also included a claim that the full and refined totex models do not forecast sufficient expenditure to take account of their enhancement programme. Our analysis and conclusions on this claim are set out in annex 1 to the [wholesale water and wastewater technical appendix](#).
2. This adjustment has been made to the underlying models that calculate the basic cost threshold and so is not reflected as a deep dive in table AA1.1.
3. This adjustment is required so that the draft determination threshold includes the cost of an overlap scheme accepted at the last price review without applying any further assumptions regarding efficiency.

Annex 2 Household retail revenue modification

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

Table AA2.1 sets out the amount per customer, by customer type, that allowed revenues will be modified by if outturn customer numbers differ from forecast customer numbers and table AA.2.2 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	18.58	18.94	19.31	19.58	19.85
Metered water only customer	25.84	25.98	26.13	26.19	26.46

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	237.654	199.321	161.966	125.099	88.720
Metered water only	598.142	644.552	690.288	734.942	779.060

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 South East 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)	-2.750	-7.204
Revenue correction mechanism (RCM)	21.265	20.141
Opex incentive allowance – post-tax (OIA)	3.678	3.678
Capital expenditure incentive scheme (CIS) ¹	-8.265	-8.211
Tax refinancing benefit clawback	0.000	0.000
Other tax adjustments	0.000	0.000
Equity injection clawback	-2.275	-2.099
Other adjustments	0.000	0.000
Total wholesale legacy adjustments	11.653	6.305

Notes:

Totals may not add up due to rounding.

¹For 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 AA3.17. 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 difference of views reflects the reward/penalty calculation using updated industry performance statistics and company turnover.

Table AA3.2 SIM annualised rewards (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-0.55	-0.55	-0.55	-0.55	-0.55	-2.75
Ofwat view	-1.441	-1.441	-1.441	-1.441	-1.441	-7.204

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 South East 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	4.253	4.253	4.253	4.253	4.253	21.265
Ofwat view	4.028	4.028	4.028	4.028	4.028	20.141

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

Area of intervention	What we did	Why we did it
Backbilling amounts	Our assumptions for the draft determination exclude the back billed amounts claimed by the company.	<p>We have concerns as to whether the back billing amounts that the company claimed are compliant with RAG4.04 and IN11/04.</p> <p>The company has not demonstrated that:</p> <ul style="list-style-type: none"> • it has calculated the amounts in accordance with the overall principal that it is the lesser of: <ul style="list-style-type: none"> i. the future extra revenue billed up to March 2015 as a result of correcting historical under billing; or ii. the associated back billing • it has received all outstanding back-billed amounts due from the customer; • it has claimed for back billed amounts where the inaccuracy of the charging is the customer's fault; or • it has taken a reasonable, fair and appropriate approach for the back-billed amounts claimed
PR14 discount rate	Our assumption for the PR14 discount rate for the draft determination is 3.7%. This has been applied for all companies for the RCM adjustment.	The company proposed a PR14 discount rate of 4.06%. The company did not provide sufficient evidence to demonstrate that an uplift to our assumed PR14 discount rate of 3.7% was acceptable.

Area of intervention	What we did	Why we did it
Household revenues	Our assumption for the draft determination uses the data the company submitted in business plan table W17 to calculate our view of the RCM adjustment.	There are inconsistencies with the household revenues between business plan table W17 and the company's populated RCM model.
FD09 assumptions	Our assumption for the draft determination includes our view of the FD09 inputs and assumptions.	There are inconsistencies between the company's and our view of the FD09 inputs and assumptions used in the company's populated RCM model.
Number of households billed	Our assumption for the draft determination uses the data the company submitted in business plan table R3 to calculate our view of the RCM adjustment.	There are inconsistencies with the number of households billed between business plan table R3 and the company's populated RCM model.

Operating expenditure incentive allowance (OIA)

Table AA3.5 below summarises the company's view and our view of the incentive allowances for 2015-20. Table AA3.6 summarises our interventions in relation to South East 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	3.678	0.000	0.000	0.000	0.000	3.678
	Ofwat view	3.678	0.000	0.000	0.000	0.000	3.678

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

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

Change protocol (logging up, logging down and shortfalls)

Tables AA3.7 and AA3.8 below summarise South East Water's view and our baseline view that no adjustments are required for:

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

Table AA3.9 confirms that we do not propose any interventions in relation to South East 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)	0.000	0.000
Shortfalls (one sided)	0.000	0.000

Notes:

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

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

2009-10 to 2014-15 – post-efficiency opex	Company view	Ofwat view
Logging up	0.000	0.000
Logging down	0.000	0.000
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
There are no interventions in this area	NA	NA

Service standard outputs

The final determination supplementary reports in 2009 contained defined project(s) where the primary output was the service standard specified¹. These outputs were set out to recognise that companies may decide to prioritise investment differently in order to achieve the service output in a more innovative and efficient manner, while still holding the company to account for the benefits to customers and the environment.

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

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

For the purposes of these draft determinations, we will not applying shortfalls on this issue conditional upon this information being provided as part of companies' draft determination representations. We would expect companies to respond to this issue in their representations. If they do not provide adequate evidence to demonstrate achievement of the service

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

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 South East 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 South East 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	Deteriorating	Deteriorating	Deteriorating
Water non infrastructure	Company view	Stable	Stable	Stable	Stable	Stable
	Ofwat view	Stable	Stable	Stable	Stable	Stable

Notes:

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

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

2009-10 to 2014-15	Water service
Amount subtracted from RCV	Company view 0.0
	Ofwat view -17.3

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

Area of intervention	What we did	Why we did it
Unplanned interruption to supply exceeding 12 hours	For the purposes of the draft determination we have assumed a shortfall adjustment of £20.2m (£17.3m post efficiency) for deteriorating performance in this indicator. In accordance with our shortfall calculation methodology we have applied a cap at 2 SD's to the shortfall in each year between 2011-12 and 2014-15, to limit the impact of specific measures and scaling factors ² . The overall scale of the shortfall does not exceed 50% of the sub-service capital expenditure and therefore no further cap has been applied.	The company has had three breaches of the upper control limit in 2011-12, 2012-13 and 2013-14. The company has provided some evidence to show the impact of single events affecting larger numbers of properties. However, we do not consider that these events should be excluded from the analysis, as they were within the company's control and were events which could have been mitigated. The company also considers that there is an overlap with SIM, however, we do not agree with this view. We have reviewed the

² The shortfall calculation methodology is detailed in the [wholesale water and wastewater technical appendix](#).

Area of intervention	What we did	Why we did it
	We would expect the company to demonstrate its latest performance as part of its representations and in advance of the final determination.	overlap with SIM and determined that the company has not provided sufficient evidence to demonstrate the connection between Interruptions >12 hours events and the SIM measures. Therefore, we have assumed for the purposes of the draft determination a shortfall adjustment for deteriorating performance in this indicator.
Water treatment works coliforms non-compliance	For the purposes of the draft determination we have assumed no Intervention. This is conditional upon the performance in 2014-15 being improved to a position such that it could be considered as stable. We may consider a shortfall adjustment if this is not achieved. We would expect the company to demonstrate its latest performance as part of its representations and in advance of the final determination.	The company's performance has remained at the upper control limit in 2011-12 and 2012-13. Performance has improved to below the reference level in 2013-14. The company has forecast 2014-15 to outturn at the reference level. We require the company to demonstrate stable serviceability in 2014-15, if this is not achieved, we may consider a shortfall adjustment.

The 2009 agreed overlap programme

Table AA3.13 below confirms the 2009 agreed overlap programme assumptions included in this draft determination. Table AA3.14 summarises our interventions in relation to South East Water's proposed adjustments for the PR09 agreed overlap programme.

**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	4.949	0.000
Ofwat view	0.000	0.000	4.949	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
There are no interventions in this area.	N/A	N/A

The 2014-15 transition programme

Table AA3.15 below confirms that South East Water did not propose a transition programme and table AA3.16 confirms that we have not made any intervention in relation to South East Water's proposal.

Table AA3.15 Transition programme in 2014-15

Net capital expenditure	2014-15 (£ million)	Proportion of forecast in 2014-15	Proportion of capital programme in 2015-20
Water service	0.000	0.00%	0.00%

Table AA3.16 Interventions on proposed transition programme

Capex scheme	What we did	Why we did it
The company did not propose a transition programme.	N/A	N/A

Capital expenditure incentive scheme (CIS)

Table AA3.17 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 AA3.18 sets out the profiled values of the revenue adjustments in each year 2015-20.

Table AA3.17 Legacy true-up adjustments

		Water service
Restated FD09 CIS bid ratio	Company view	129.010
	Ofwat view	129.010
Outturn CIS ratio¹	Company view	115.116
	Ofwat view	115.116
Incentive reward/penalty (%)	Company view	-4.446
	Ofwat view	-4.446
Reward/penalty (£m)²	Company view	-16.633
	Ofwat view	-16.633
Adjustments to 2015-20 revenue (£m)³	Company view	-7.645
	Ofwat view	-7.646
CIS adjustment to RCV (£m)	Company view	7.464
	Ofwat view	7.464
Commentary		
The company has broadly applied the published Ofwat methodology. However the company used its submitted cost of capital (4.06%) as the discount rate when profiling the revenue adjustment. Our assumption of the discount rate for the PR14 draft determination is 3.70%. We used this value when profiling the revenue adjustment.		

Notes:

¹The restated FD09 CIS bid ratio takes account of the adjustments for the change protocol (table AA3.7) and the 2009 agreed overlap programme (table AA.3.13).

²The 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.

³The 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 AA3.18 Profiled revenue adjustments from the CIS reconciliation (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	-1.653	-1.653	-1.653	-1.653	-1.653	-8.265
Ofwat view	-1.642	-1.642	-1.642	-1.642	-1.642	-8.211

Other adjustments

Table A3.19 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 AA3.19 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	-2.275	-2.099	The company chose to spread the equity injection clawback over the 2015-20 period. We have assumed that this will occur in the 2015-16 year.
Other adjustments	0.000	0.000	No adjustment was proposed by the company.

Annex 4 Outcomes, performance commitments and outcome delivery incentives

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

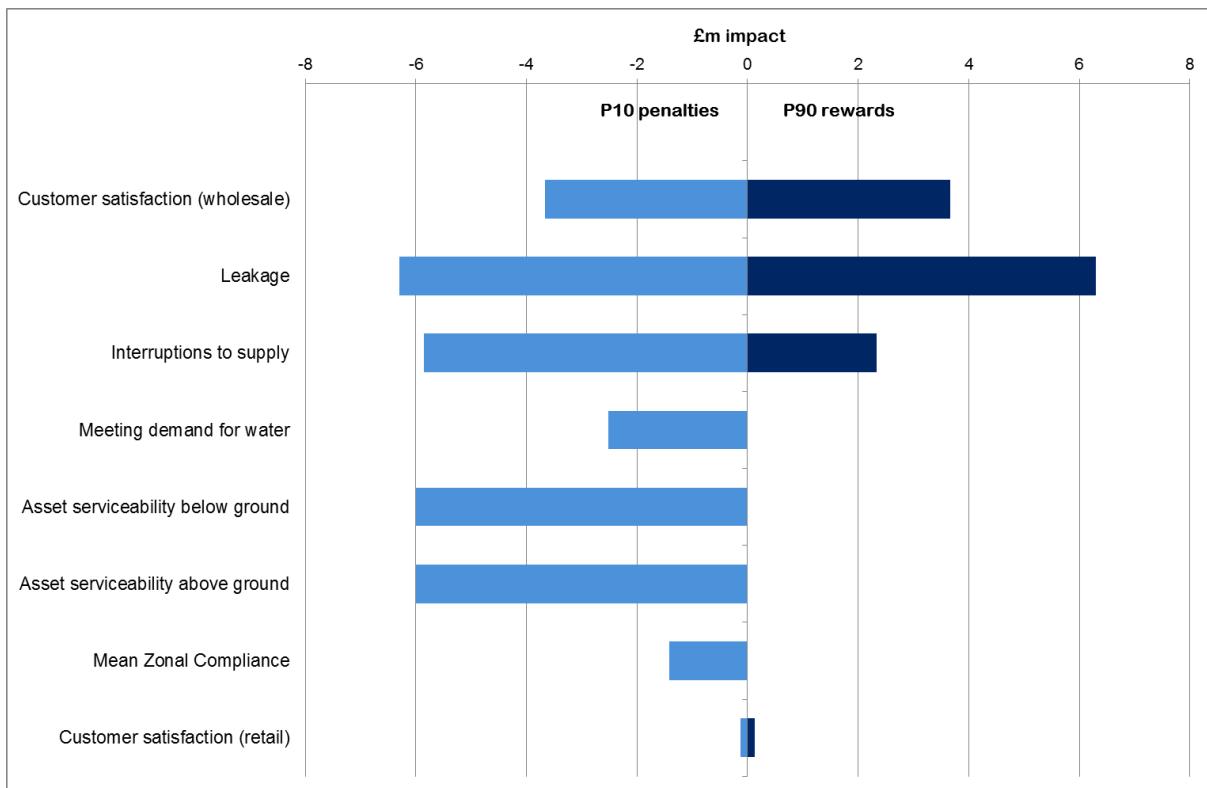
The two figures below first provide an overview of these performance commitments and ODIs. Figure AA4.1 shows the balance between reward and penalty, penalty only and reputational incentives in the package of proposed incentives for the company and figure AA4.2 shows the potential financial impact of each of the financial incentives proposed.

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

Number of performance commitments (after intervention)	Reward and penalty	Penalty only	Non-financial incentives
Wholesale Water	10	3	10
Household Retail	8	0	1

The following graph shows the potential financial consequences of the individual financial ODIs. The figures represent the penalties and rewards associated with the p10 and p90 scenarios over the 5 years (2015-16 to 2019-20). This means there is a 10% chance of performance being higher or lower than these assumed levels. In most cases the potential maximum will be bigger but is very unlikely to occur. The p10 and p90 scenarios therefore represent a more realistic estimate of potential financial impacts.

Figure AA4.2 Overview of financial ODIs



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

There are a small number of specific exclusions from the cap/collar for some companies, but there are no such exclusions for South East Water.

Tables AA4.1 and AA4.2 set out a more detailed explanation of our interventions in the company's wholesale water and household retail outcomes.

Table AA4.1 Summary of interventions on wholesale water outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
PCs – A1, B1, D1, F1, G1 and H1 (Survey of customer satisfaction measures)	We increased the penalty ranges to 1 (one) full index point. That is, we made the difference between the performance commitment level and the penalty collar 1.0 (one index point).	Incentive Rates not justified: South East Water proposed an innovative approach of basing some of its performance commitments on surveys of customer satisfaction. The company's willingness to pay survey found that customers were willing to pay much less for an improvement in customer satisfaction than they would need to be paid to accept the same decline in customer satisfaction. To reflect the asymmetry in customer's views we considered different ways of making these performance commitments asymmetric.
A1 – Customers consider the appearance of their water to be acceptable		In its December 2013 business plan South East Water had proposed asymmetric penalty and reward deadbands, so we have adopted that approach, but using a slightly larger penalty range. This means the company will incur larger penalties if its performance drops significantly on these performance commitments. This is consistent with South East Water's customers' views expressed in its willingness to pay survey.
B1 – Customers consider the taste and odour of their water to be acceptable		
D1 – Customers consider their direct interaction experience to be positive		
F1 – Customers consider the water supply is of sufficient pressure		
G1 – Customers consider the frequency and duration of supply interruptions is acceptable		
H1 – Customers consider the frequency of water use restrictions to be acceptable.		
C2 – Leakage target	We increased the penalty collar from 94.1 Ml/day to 96.9	Horizontal consistency check: We carried out a horizontal comparison of leakage across the industry. The comparison

PC/ODI affected	What we did	Why we did it
	MI/day in 2019-20 with similar changes to the preceding years (see annex 4 for precise details).	identified that South East Water's penalty range was not sufficiently wide when compared to other companies. We therefore increased the penalty collar in each year of over 2015-20.
G2 – Average time lost per property	We reduced the PC to 10 minutes from 2017-18 with a glidepath from current performance (see annex 4 for precise details). We reduced the penalty deadband to 10 minutes from 2017-18. We reduced the penalty collar to 20 minutes for each year over 2015-20.	Horizontal consistency check: We carried out a horizontal comparison of interruptions to supply across the industry. Consistent with our approach to other companies we reduced the performance commitment level and penalty deadband to 10 minutes (upper quartile) from 2017-18. We reduced the penalty collar to approximately maintain the company's proposed maximum penalty.
H2 – Meeting demand for water (SOSI)	We have removed the reward.	Incentive rate not justified: We have removed the reward on the security of supply index for consistency with other companies, none of whom had proposed a reward on SOSI. We also removed the reward on SOSI because South East Water did not provide sufficient evidence that a reward for SOSI = 100 represented stretching performance given that the company has achieved 100 in the last 5 years.
I1 – Mean Zonal Compliance	We have applied a financial penalty. We have applied a penalty deadband of 99.96% and a penalty collar of 99.95% for each year over 2015-20.	Horizontal consistency check: We carried out a horizontal comparison of mean zonal compliance across the industry. This comparison revealed that South East Water was one of a small number of companies without a financial penalty on mean zonal compliance. Consistent with our approach to other companies we have applied a penalty to this performance commitment. We have added a penalty collar, penalty

PC/ODI affected	What we did	Why we did it
		<p>deadband and incentive rate based on the average of water-only companies (WoCs). That is, for the five years 2015-16 to 2019-20, a penalty collar of 99.95% and a penalty deadband of 99.96%. The incentive rate has been set at the WoC average of 0.284 (£m/0.01%/year).</p> <p>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>
N1 – Below ground asset performance assessment (infrastructure)	We have removed the reward.	<p>Incentive not justified: We have removed the reward because South East Water has not provided sufficient evidence that its customers want the company to deliver more in relation to asset performance nor that the reward would be for stretching performance.</p> <p>South East Water could propose a revised approach which allowed rewards only for the customer-facing sub-measures of pressure and customer contacts for discolouration. South East Water would need to justify any such rewards, for example, by reference to customers' willingness to pay.</p>
N2 – Above ground asset performance assessment (non-infrastructure)	We have removed the reward.	<p>Incentive not justified: We have removed the reward because South East Water has not provided sufficient evidence that its customers want the company to deliver more in relation to asset performance nor that the reward would be for stretching performance.</p>

Table AA4.2 Summary of interventions on household retail outcomes, performance commitments and incentives

PC/ODI affected	What we did	Why we did it
PCs – A1, B1, D1, F1, G1 and H1 (Survey of customer satisfaction measures) A1 – Customers consider the appearance of their water to be acceptable B1 – Customers consider the taste and odour of their water to be acceptable D1 – Customers consider their direct interaction experience to be positive F1 – Customers consider the water supply is of sufficient pressure G1 – Customers consider the frequency and duration of supply interruptions is acceptable H1 – Customers consider the frequency of water use restrictions to be acceptable.	We increased the penalty ranges to 1 (one) full index point. That is, we made the difference between the performance commitment level and the penalty collar 1.0 (one index point).	<p>Incentive Rates not justified: South East Water proposed an innovative approach of basing some of its performance commitments on surveys of customer satisfaction. The company's willingness to pay survey found that customers were willing to pay much less for an improvement in customer satisfaction than they would need to be paid to accept the same decline in customer satisfaction. To reflect the asymmetry in customer's views we considered different ways of making these performance commitments asymmetric.</p> <p>In its December 2013 business plan South East Water had proposed asymmetric penalty and reward deadbands, so we have adopted that approach, but using a slightly larger penalty range. This means the company will incur larger penalties if its performance drops significantly on these performance commitments. This is consistent with South East Water's customers' views expressed in its willingness to pay survey.</p>

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

PC/ODI affected	What we did	Why we did it
We have not intervened on any household retail outcomes.		

Outcome delivery and reporting

In the [outcomes technical appendix](#), we outline a framework against which we have assessed South East Water's proposals in relation to 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.

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

Table AA4.4 South East Water's proposals for outcome delivery and reporting

South East Water proposals	Our assessment
<p>South East Water has described its proposed approach to outcome measurement, reporting and governance in its Wholesale Plan, Retail Plan, APP16 (outcomes and incentives) and PR14 Further Supporting Evidence June 2014 submission documents. The company states the following.</p> <ul style="list-style-type: none"> It will participate in regular performance monitoring of both the wholesaler's and the retailer's activity. This will be managed by the retailer and delivered via a quarterly meeting of cross-company Directors, along with a nominated independent Non-Executive Director of the South East Water Board, and the Chair of its newly-created 	<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>South East Water has provided sufficient evidence demonstrating the approach it will undertake to ensure the PCs will be measured and reported consistently, and the scope of proposed governance and assurance processes. Therefore, we have accepted the company's proposal.</p>

South East Water proposals	Our assessment
<p>Customer Panel.</p> <ul style="list-style-type: none"> • Its performance will be measured through customer tracker surveys conducted by an independent market research company, while the design of the research surveys, measurement and averaging of scores, will be scrutinised and assured by the new Customer Panel. • It will publish its performance against the outcomes and performance commitments, in the design of the outcomes dashboard, annually in their Annual Performance Report. • Performance monitoring will be subject to independent peer review and an audit process which will be published annually to give confidence in the monitoring process. The company's performance will be measured quarterly, and with an annual average score calculated and reported annually through the Annual Performance Report which will be independently assured through the Annual Performance Report governance and assurance procedures. • The Board will ensure that future monitoring, reporting and governance of the commitments is delivered transparently and independently. This will be achieved in part by the company's future Customer Panel. 	<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 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 applicable¹; 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 our intervention is to remove the performance commitment in question, details and reasoning are provided in table AA4.1 at the end of this annex. Where we have amended the company's proposed incentive but retained the performance commitment, we have intentionally set out our interventions below using a ~~strikethrough~~. What this means is that we have rejected the proposal that has been struck through and instead we have either used a different value or not included a value at all (for example, in the case of some rewards).

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

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

Performance commitment	Reason for its removal
We have not removed any performance commitments	

¹ 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.

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

Performance commitment	Reason for its addition
We have not added any performance commitments	

Wholesale water outcome [A]: Customers consider the appearance of their water to be acceptable

Performance commitment [A1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Penalty collar	Score out of 5		4.2	4.2	4.2	4.2	4.2	4.2
			3.6	3.6	3.6	3.6	3.6	3.6
Penalty deadband	Score out of 5		4.5	4.5	4.5	4.5	4.5	4.5
Reward deadband	Score out of 5		4.7	4.7	4.7	4.7	4.7	4.7
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.2	4.5	0.016

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.6	
Reward	4.7	5.0 0.016

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 90%.

Wholesale water outcome [B]: Customers consider the taste and odour of their water to be acceptable

Performance commitment [B1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Penalty collar	Score out of 5		3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3
Penalty deadband	Score out of 5			4.2	4.2	4.2	4.2	4.2
Reward deadband	Score out of 5			4.4	4.4	4.4	4.4	4.4
Reward cap	Score out of 5			5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.6	4.2	0.031

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.3	
Reward	4.4	5.0 0.031

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 90%.

Wholesale water outcome [C]: Customers consider the level of leakage to be acceptable

Performance commitment [C1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	3.6	4.0	4.0	4.0	4.0	4.0	4.0
Penalty collar	Score out of 5		3.0	3.0	3.0	3.0	3.0	3.0
Penalty deadband	Score out of 5		3.9	3.9	3.9	3.9	3.9	3.9
Reward deadband	Score out of 5		4.1	4.1	4.1	4.1	4.1	4.1
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.0	3.9	0.037

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
Reward	4.1	5.0

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 70%.

Performance commitment [C2]: Leakage

Detailed definition of performance measure:

Actual reported leakage per Ml/d per year. Calculation of leakage as defined for the Ofwat KPI in IN 13/03 adjusted to reflect post MLE (maximum-likelihood estimation) calculation.

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	

		Starting level	Committed performance levels					
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	
PC	MI/d	93.0	91.8	90.9	90.0	89.1	88.1	
Penalty collar	MI/d		97.8	96.9	96.0	95.1	94.1	
			101.0	100.0	99.0	98.0	96.9	
Penalty deadband	MI/d		92.8	91.9	91.0	90.1	89.1	
Reward deadband	MI/d		90.8	89.9	89.0	88.1	87.1	
Reward cap	MI/d		85.8	84.9	84.0	83.1	82.1	

Incentive rates

Incentive type	Performance levels (MI/d)		Incentive rate (£m/MI/d/year)
	Lower	Upper	
Penalty	89.1	94.4	0.315
		101.0	
Reward	82.1	87.4	0.315
		90.8	

Additional details

Necessary detail on measurement units	Measured to 1 decimal place.
Frequency of PC measurement and any use of averaging	PC measured on an annual basis.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or	PC reported on post MLE basis.

**clarifications relevant to correct
application of incentive**

Wholesale water outcome [D]: Customers consider their direct interaction experience to be positive

Performance commitment [D1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Penalty collar	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
			3.5	3.5	3.5	3.5	3.5	3.5
Penalty deadband	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
Reward deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.0	4.4	0.008

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.5	
Reward	4.6	5.0 0.008

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 20%.

Performance commitment [D2]: Service Incentive Mechanism

Detailed definition of performance measure:

SIM score as defined in the latest Ofwat's guidance.

Incentive type:

Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels

	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score	78					>80

Incentive rates

Incentive type	Performance levels (score)		Incentive rate (score)
	Lower	Upper	
Penalty and reward	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	SIM score calculated using the methodology outlined in the performance measure definition.
Frequency of PC measurement and any use of averaging	PC measured on an annual basis.
Timing and frequency of rewards/penalties	Under the existing mechanism for SIM, any reward or penalty will be applied in the 2019 price setting process.
Form of reward/penalty	Under the existing mechanism for SIM, any reward or penalty will be an adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Reward or penalty is applied under the existing mechanism, no additional incentive rates apply. Delivery of performance commitment and incentive shared with retail household. Wholesale share equals 40%.

Wholesale water outcome [E]: Customers consider bills to be value for money and affordable

Performance commitment [E1]: Customer Satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a percentage.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels					
	Unit		2015-16	2016-17	2017-18	2018-19	2019-20	
PC	%	72						>80

Additional details

Necessary detail on measurement units	Score measured as percentage and rounded to a whole percentage point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated. Commitment made for 2019-20. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment shared with retail household. Wholesale share equals 75%.

Wholesale water outcome [F]: Customers consider their water supply is of sufficient pressure

Performance commitment [F1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Penalty collar	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
			3.5	3.5	3.5	3.5	3.5	3.5
Penalty deadband	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
Reward deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.0	4.4	0.027

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.5	
Reward	4.6	5.0 0.027

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with household retail. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 90%.

Performance commitment [F2]: Number of properties at risk of low pressure

Detailed definition of performance measure:

Number of properties at risk of low pressure, as recorded on the DG2 register.

Incentive type: Reputational

Performance commitments

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

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	60	60	60	60	60	60	60

Additional details

Necessary detail on measurement units	Properties recorded as per DG2 definition applied within serviceability assessment.
Frequency of PC measurement and any use of averaging	Measured and reported annually. DG2 methodology for recording. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [G]: Customers consider the frequency and duration of supply interruptions is acceptable

Performance commitment [G1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Penalty collar	Score out of 5		4.4 3.7	4.4 3.7	4.4 3.7	4.4 3.7	4.4 3.7	4.4 3.7
Penalty deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward deadband	Score out of 5		4.8	4.8	4.8	4.8	4.8	4.8
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
Penalty	4.4	4.6	0.006
	3.7		
Reward	4.8	5.0	0.006

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 90%.

Performance commitment [G2]: Average time lost per property

Detailed definition of performance measure:

Average time lost, in minutes, per property served, as calculated and defined in the Ofwat KPI in IN 13/03.

Incentive type:

Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Minutes	13	13 12	13 11	13 10	13 10	13 10
Penalty collar	Minutes		30 20	30 20	30 20	30 20	30 20
Penalty deadband	Minutes		22 13	22 13	22 10	22 10	22 10
Reward deadband	Minutes		7	7	7	7	7
Reward cap	Minutes		0	0	0	0	0

Incentive rates

Incentive type	Performance levels (minutes)		Incentive rate (£m/minute/year)
	Lower	Upper	
Penalty	22 10	30 20	0.133
	0	7	
Reward			0.133

Additional details

Necessary detail on measurement units	As calculated and defined in the Ofwat KPI in IN 13/03.
Frequency of PC measurement and any use of averaging	PC measured and reported annually.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue

Any other information or clarifications relevant to correct application of incentive	n/a
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Wholesale water outcome [H]: Customers consider the frequency of water use restrictions to be acceptable

Performance commitment [H1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Penalty collar	Score out of 5		3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1
Penalty deadband	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
Reward deadband	Score out of 5		4.2	4.2	4.2	4.2	4.2	4.2
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.2	4.0	0.024

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.1	
Reward	4.2	5.0 0.024

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Wholesale share equals 90%.

Performance commitment [H2]: Meeting demand for water Security of Supply Index

Detailed definition of performance measure:

Measured by the Security of Supply Index (SOSI) score. As defined by the Ofwat KPI in IN 13/03.

Incentive type:

Financial – penalty only.

~~Financial – reward and penalty.~~

Performance commitments

		Starting level	Committed performance levels					
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	
PC	Score	100	100	100	100	100	100	
Penalty collar								
Penalty deadband	Score		99	99	99	99	99	
Reward deadband			-	-	-	-	-	
Reward cap			-	-	-	-	-	

Incentive rates

Incentive type	Performance levels (Score)		Incentive rate (£m/pass or fail/year)
	Lower	Upper	
Penalty	98	99	0.504
Reward	100	100	0.504

Additional details

Necessary detail on measurement units	As calculated and defined in the Ofwat KPI in IN 13/03.
Frequency of PC measurement and any use of averaging	Calculated and reported annually.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Measured as a pass or fail.

Wholesale water outcome [I]: We are compliant with water quality regulations

Performance commitment [I1]: Mean Zonal Compliance

Detailed definition of performance measure:

The mean zonal compliance percentage, based on current regulations and standards and as reported to the Drinking Water Inspectorate (DWI).

Incentive type: Reputational.

Financial – penalty only.

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	100	100	100	100	100	100	100
Penalty collar	%		99.95	99.95	99.95	99.95	99.95	99.95
Penalty deadband	%		99.96	99.96	99.96	99.96	99.96	99.96

Incentive rates

Incentive type	Performance levels (Score)		Incentive rate (£m/0.01%/year)
	Lower	Upper	
Penalty	99.95	99.96	0.284

Additional details

Necessary detail on measurement units	Score measured as percentage. Reported to two decimal places.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.

	<p>Calendar year calculation and reporting.</p> <p>Performance will be published annually in the Annual Performance Report.</p> <p>Performance reviewed by the Customer Panel.</p>
Timing and frequency of rewards/penalties	<p>Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process.</p> <p>Calculation and accrual of incentive reviewed by the Customer Panel.</p>
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [J]: We are compliant with environmental regulations

Performance commitment [J1]: Number of breaches of abstraction licences, discharge consents and environmental permits

Detailed definition of performance measure:

The number of breaches as measured by the reporting procedures to the Environment Agency.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	0	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	Number of breaches.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment [J2]: Number of pollution incidents

Detailed definition of performance measure:

The number of category 1 or 2 pollution incidents. As reported to the Environment Agency.

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	0	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	Number of pollution incidents.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [L]: We are compliant with National Security standards

Performance commitment [L1]: Number of compliance breaches

Detailed definition of performance measure:

The number of compliance breaches of the Security and Emergency Measures Directive (SEMD).

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	0	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	Number of breaches. Failure to deliver the required activities to meet Defra Advice Notes under SEMD.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [K]: We are compliant with health and safety regulations

Performance commitment [K1]: Number of breaches of legislation

Detailed definition of performance measure:

The number of breaches of health and safety regulations, as defined by the Health and Safety Executive.

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	0	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	Number of breaches.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [M]: We are compliant with statutory obligations and licence conditions

Performance commitment [M1]: Number of compliance breaches

Detailed definition of performance measure:

The number of compliance breaches with our statutory obligations and licence conditions.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	nr	0	0	0	0	0	0	0

Additional details

Necessary detail on measurement units	Number of compliance breaches.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [N]: Our assets are capable of delivering outcomes in the future

Performance commitment [N1]: Below ground asset performance assessment

Detailed definition of performance measure:

Serviceability assessment of below ground asset performance. Assessed as stable or marginal. Definition of assessment set out in the company business plan and further supporting evidence document.

Incentive type:

~~Financial reward and penalty.~~

Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Assessment	Stable	Stable	Stable	Stable	Stable	Stable	Stable
Penalty collar	Assessment							See additional details below
Penalty deadband	Assessment							
Reward deadband	Assessment							
Reward cap	Assessment							

Incentive rates

Incentive type	Performance levels (assessment)		Incentive rate (£m/pass or fail/year or AMP)
	Lower	Upper	

Incentive type	Performance levels (assessment)		Incentive rate (£m/pass or fail/year or AMP)
Penalty	2 x marginal	3 x marginal	4.000 per year
Reward	5 x stable	5 x stable	6.000 for AMP

Additional details

Necessary detail on measurement units	Measurement based on serviceability indicators, reference limits and upper control limits, set out in the Company business plan.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported annually. Performance will be published annually in the Annual Performance Report. Performance reviewed by the Customer Panel.
Timing and frequency of rewards/penalties	Reward requires stable assessment in all five years. Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to RCV.
Any other information or clarifications relevant to correct application of incentive	The penalty applies when marginal is reported in three consecutive years, and each consecutive marginal year thereafter, until at least two consecutive stable years. The first stable year following 3 or more marginal years will attract a penalty of 50% of the total penalty. Only after two consecutive stable years would the cumulative marginal assessment be re-set. Reporting frequency to Customer Panel increased to quarterly when one indicator is above the upper limit for two consecutive years or when two indicators are above the upper limit in any year. Reporting frequency to Ofwat increased to every six months when two indicators are above the upper limit and quarterly when more than two are above the upper limit in any year.

Performance commitment [N2]: Above ground asset performance assessment

Detailed definition of performance measure:

Serviceability assessment of above ground asset performance. Assessed as stable or marginal. Definition of assessment set out in the company business plan and further supporting evidence document.

Incentive type:

~~Financial reward and penalty.~~

Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Assessment	Stable	Stable	Stable	Stable	Stable	Stable	Stable
Penalty collar	Assessment							See additional details below
Penalty deadband	Assessment							
Reward deadband	Assessment							
Reward cap	Assessment							

Incentive rates

Incentive type	Performance levels (assessment)		Incentive rate (£m/pass or fail/year or AMP)
	Lower	Upper	

Incentive type	Performance levels (assessment)		Incentive rate (£m/pass or fail/year or AMP)
Penalty	2 x marginal	3 x marginal	4.000 per year
Reward	5 x stable	5 x stable	6.000 for AMP

Additional details

Necessary detail on measurement units	Measurement based on serviceability indicators, reference limits and upper control limits, set out in the Company business plan.
Frequency of PC measurement and any use of averaging	Performance commitment measured and reported annually. Performance will be published annually in the Annual Performance Report. Performance reviewed by the Customer Panel.
Timing and frequency of rewards/penalties	Reward requires stable assessment in all five years. Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to RCV
Any other information or clarifications relevant to correct application of incentive	The penalty applies when marginal is reported in three consecutive years, and each consecutive marginal year thereafter, until at least two consecutive stable years. The first stable year following 3 or more marginal years will attract a penalty of 50% of the total penalty. Only after two consecutive stable years would the cumulative marginal assessment be re-set. Reporting frequency to Customer Panel increased to quarterly when one indicator is above the upper limit for two consecutive years or when two indicators are above the upper limit in any year. Reporting frequency to Ofwat increased to every six months when two indicators are above the upper limit and quarterly when more than two are above the upper limit in any year.

Performance commitment [N3]: Number of sites at risk of flooding

Detailed definition of performance measure:

The number of Company sites at risk of flooding as defined in the business plan.

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2015-16	2016-17	2017-18	2018-19	2019-20	
PC	nr	55					0	

Additional details

Necessary detail on measurement units	n/a
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Wholesale water outcome [O]: We will reduce our impact on the environment

Performance commitment [O1]: Carbon emissions per customer per year

Detailed definition of performance measure:

Average kg of carbon emissions per customer.

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2015-16	2016-17	2017-18	2018-19	2019-20	
PC	kg	39.4						38.7

Additional details

Necessary detail on measurement units	Total carbon emissions divided by total number of customers supplied.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Performance commitment [O2]: Monitor our abstraction at low flows at environmentally sensitive sites

Detailed definition of performance measure:

Measure and commitment to be defined in line with the Abstraction Incentive Mechanism (AIM).

Incentive type: Reputational

Performance commitments

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

Additional details

Necessary detail on measurement units	To be defined when robust data available for Abstraction Incentive Mechanism.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually. Performance will be published in the Annual Performance Report. Performance reviewed by the Customer Panel.
Any other information or clarifications relevant to correct application of incentive	n/a

Household retail outcome [A]: Customers consider the appearance of their water to be acceptable

Performance commitment [A1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Penalty collar	Score out of 5		4.2	4.2	4.2	4.2	4.2	4.2
			3.6	3.6	3.6	3.6	3.6	3.6
Penalty deadband	Score out of 5		4.5	4.5	4.5	4.5	4.5	4.5
Reward deadband	Score out of 5		4.7	4.7	4.7	4.7	4.7	4.7
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.2	4.5	0.016

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.6	
Reward	4.7	5.0 0.016

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 10%.

Household retail outcome [B]: Customers consider the taste and odour of their water to be acceptable

Performance commitment [B1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Penalty collar	Score out of 5		3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3	3.6 3.3
Penalty deadband	Score out of 5		4.2	4.2	4.2	4.2	4.2	4.2
Reward deadband	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.6	4.2	0.031

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.3	
Reward	4.4	5.0 0.031

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 10%.

Household retail outcome [C]: Customers consider the level of leakage to be acceptable

Performance commitment [C1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	3.6	4.0	4.0	4.0	4.0	4.0	4.0
Penalty collar	Score out of 5		3.0	3.0	3.0	3.0	3.0	3.0
Penalty deadband	Score out of 5		3.9	3.9	3.9	3.9	3.9	3.9
Reward deadband	Score out of 5		4.1	4.1	4.1	4.1	4.1	4.1
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.0	3.9	0.037

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
Reward	4.1	5.0

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 30%.

Household retail outcome [D]: Customers consider their direct interaction experience to be positive

Performance commitment [D1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Penalty collar	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
			3.5	3.5	3.5	3.5	3.5	3.5
Penalty deadband	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
Reward deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.0	4.4	0.008

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.5	
Reward	4.6	5.0 0.008

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 80%.

Performance commitment [D2]: Service Incentive Mechanism

Detailed definition of performance measure:

SIM score as defined in Ofwat's SIM guidance April 2012 and updated by IN 13/03.

Incentive type:

Financial – reward and penalty.

Performance commitments

		Starting level	Committed performance levels

	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score	78					>80

Incentive rates

Incentive type	Performance levels (score)		Incentive rate (score)
	Lower	Upper	
Penalty and reward	n/a	n/a	n/a

Additional details

Necessary detail on measurement units	SIM score calculated using the methodology outlined in the performance measure definition.
Frequency of PC measurement and any use of averaging	Performance commitment reported annually.
Timing and frequency of rewards/penalties	Under the existing mechanism for SIM, any reward or penalty will be applied in the 2019 price setting process.
Form of reward/penalty	Under the existing mechanism for SIM, any reward or penalty will be an adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Reward or penalty is applied under the existing mechanism, no additional incentive rates apply. Delivery of performance commitment and incentive shared with retail household. Retail share equals 60%.

Household retail outcome [E]: Customers consider bills to be value for money and affordable

Performance commitment [E1]: Customer Satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a percentage.

Incentive type: Reputational

Performance commitments

		Starting level	Committed performance levels					
	Unit		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	72						>80

Additional details

Necessary detail on measurement units	Score measured as percentage and rounded to a whole percentage point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated. Commitment made for 2019-20.
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment shared with retail household. Retail share equals 25%.

Household retail outcome [F]: Customers consider their water supply is of sufficient pressure

Performance commitment [F1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Penalty collar	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
			3.5	3.5	3.5	3.5	3.5	3.5
Penalty deadband	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
Reward deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	4.0	4.4	0.027

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.5	
Reward	4.6	5.0 0.027

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 10%.

Household retail outcome [G]: Customers consider the frequency and duration of supply interruptions is acceptable

Performance commitment [G1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Penalty collar	Score out of 5		4.4	4.4	4.4	4.4	4.4	4.4
			3.7	3.7	3.7	3.7	3.7	3.7
Penalty deadband	Score out of 5		4.6	4.6	4.6	4.6	4.6	4.6
Reward deadband	Score out of 5		4.8	4.8	4.8	4.8	4.8	4.8
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
Penalty	4.4	4.6	0.006
	3.7		
Reward	4.8	5.0	0.006

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 10%.

Household retail outcome [H]: Customers consider the frequency of water use restrictions to be acceptable

Performance commitment [H1]: Customer satisfaction

Detailed definition of performance measure:

Customer satisfaction as measured through satisfaction tracking research, as a score out of 5.

Incentive type:

Financial – reward and penalty.

Performance commitments

	Unit	Starting level	Committed performance levels					
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score out of 5	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Penalty collar	Score out of 5		3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1	3.2 3.1
Penalty deadband	Score out of 5		4.0	4.0	4.0	4.0	4.0	4.0
Reward deadband	Score out of 5		4.2	4.2	4.2	4.2	4.2	4.2
Reward cap	Score out of 5		5.0	5.0	5.0	5.0	5.0	5.0

Incentive rates

Incentive type	Performance levels (score out of 5)		Incentive rate (£m/0.1 index point/year)
	Lower	Upper	
Penalty	3.2	4.0	0.024

Incentive type	Performance levels (score out of 5)	Incentive rate (£m/0.1 index point/year)
	3.1	
Reward	4.2	5.0 0.024

Additional details

Necessary detail on measurement units	Score measured to 1 decimal place. Score rounded to nearest decimal point.
Frequency of PC measurement and any use of averaging	Quarterly satisfaction tracker survey, annual average calculated.
Timing and frequency of rewards/penalties	Incentive calculated annually and accrued to the end of the period and applied in the 2019 price setting process. Calculation and accrual of incentive reviewed by the Customer Panel.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	Delivery of performance commitment and incentive shared with retail household. Incentive rate shown equals combined incentive that is, 100%. Retail share equals 10%.

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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