

August 2014

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



OFWAT

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Overview

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

The revisions that South Staffordshire Water made to its business plan have many strengths. The company has undertaken further research and engagement with customers on the affordability of its plan, and has addressed much of our feedback from the risk-based review particularly in relation to reconciling 2010-15 performance. There are, however, some remaining areas where we are intervening to protect the interests of consumers. These relate to the adjustments for bad debt and input price pressure in the household retail control, the new costs the company proposed to the non-household retail control and on wholesale costs. The interventions in the area of outcomes and the associated delivery incentives are largely for those which are common to all companies.

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

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

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

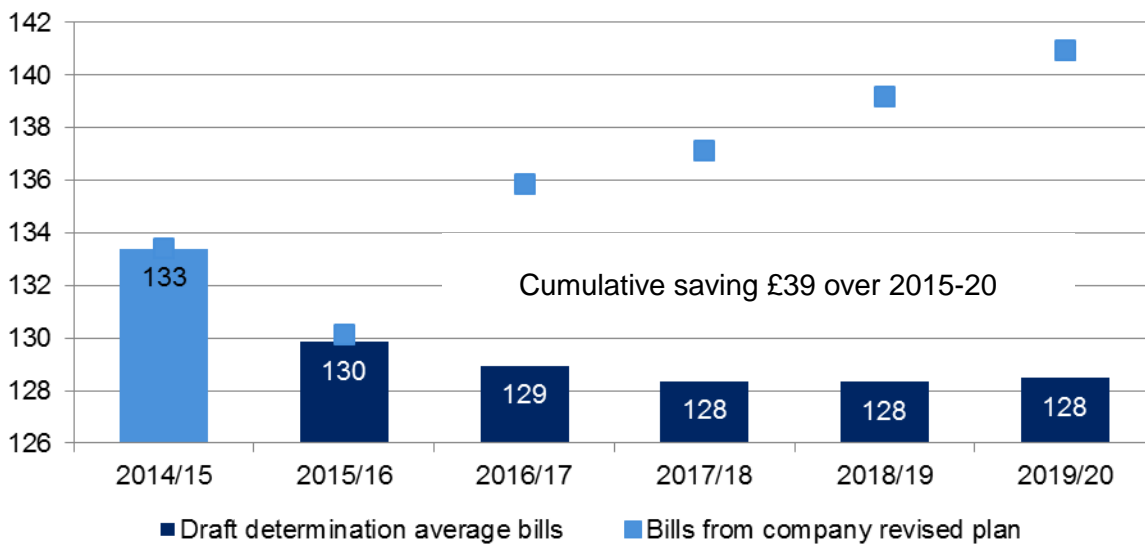
Annexes 1 to 4 form part of the draft price control determination.

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

Excellent water quality now and in the future

Secure and reliable supplies now and in the future

Operations which are environmentally sustainable

Fair customer bills and fair investor returns

Retail

An excellent customer experience to customers and the community

Allowed costs/expenditure¹

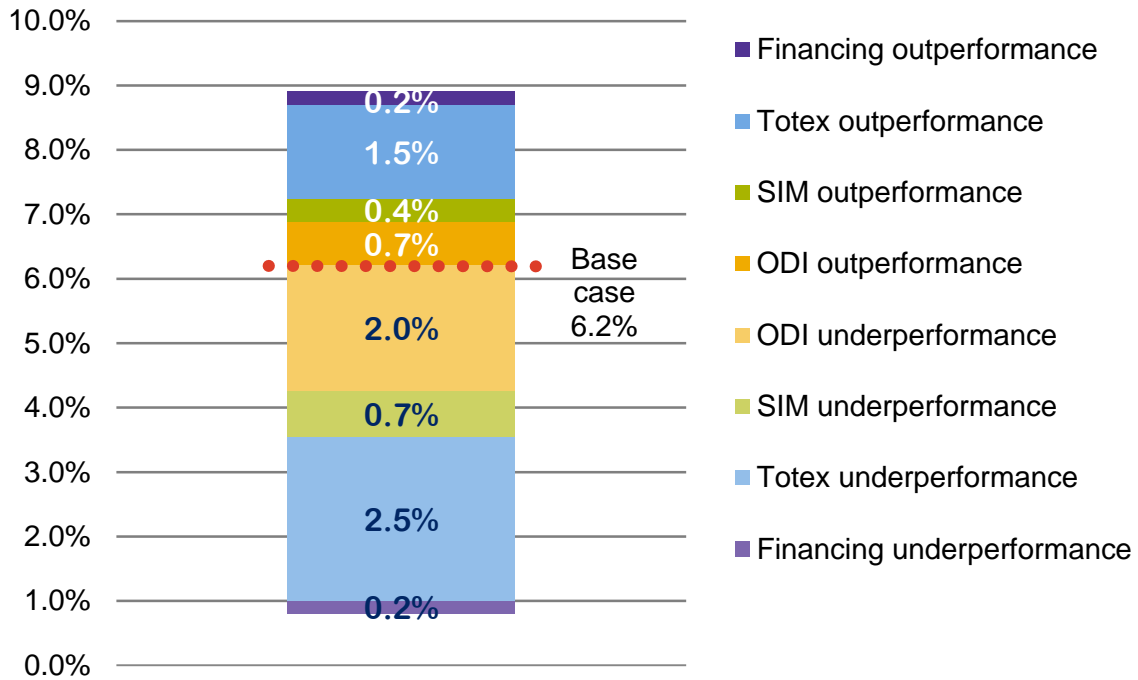
Wholesale	Water	
Totex – 2015-20 total (£m)	395.0	
Allowed weighted average cost of capital (%)	3.70%	
Allowed wholesale revenue in 2015-20 (£m)	465	
Retail	Household	Non-household
Cost allowance – 2015-20 total (£m)	69.8	
Margin (%)	1.00%	2.50%
Retail allowed revenue (£m)	74.6	11.9
Average bill per household customer – retail component only (£)	23	

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 <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 commitments, deadbands, caps and collars for five ODIs • Bottom up analysis: We require the company to provide further clarification on two performance commitments 	Wholesale costs <ul style="list-style-type: none"> • The company proposed wholesale water totex of £411 million in its plan, which is £12.5 million above our draft determination threshold of £399 million. • We have rejected some of the company's wholesale cost adjustments, or only partially allowed them. We also made some adjustments to reflect our modelling approach.
Retail <ul style="list-style-type: none"> • We have rejected the company's adjustment for input price pressure (household) • We have rejected the company's adjustment for bad debt driven by deprivation (household) • We have removed the company's proposed material new costs (non-household). 	Reconciling 2010-15 performance <ul style="list-style-type: none"> • We have intervened in the adjustments related to 2010-15 performance which has reduced the revenue requirement by £2.3 million.
Risk and reward <ul style="list-style-type: none"> • We have rejected the company specific uplift. 	Financeability and affordability <ul style="list-style-type: none"> • We have reprofiled bills so that there is a reduction in the first year with flat bills for the remainder of the period.

RoRE ranges – appointee



Ofwat’s calculations of notional financeability ratios

Financial ratios for notional company	Ofwat calculation (average 2015-20)
Cash interest cover	3.59
Adjusted cash interest cover ratio (ACICR) – base case (avg over five years)	1.46
Funds from operations/debt	12.25%
Retained cash flow/debt	9.67%
Gearing	66.93%
Dividend cover (profit after tax/dividends paid)	1.56
Regulatory equity/regulated earnings for the regulated company	15.43
RCV/EBITDA	8.57

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 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.

We summarise the outcomes, performance commitments and outcome delivery incentives for the wholesale water control for South Staffordshire Water in Table A2.1 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 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	
Excellent water quality now and in the future	Mean zonal compliance (MNZ)	Financial – penalty only	Horizontal check: Following review of upper quartile performance, PC level has been adjusted from 2017-18 and the penalty deadbands and collar changed

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
	Acceptability of water to customers	Financial – reward and penalty	Horizontal check: Following review of upper quartile performance, PC level has been adjusted from 2017-18 and the penalty and reward deadbands changed
Secure and reliable supplies now and in the future	Interruptions to supply	Financial – reward and penalty	Horizontal check: The company is already a relatively high performer, but following review of upper quartile performance, the penalty rate has been increased, penalty deadband tightened and penalty collar reduced.
	Asset serviceability – infrastructure	Financial – penalty only	Bottom-up analysis: Although no intervention has been included in the draft determination, further clarifications are required from the company to explain how it has arrived at the weightings between the sub service areas.

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
	Asset serviceability – non-Infrastructure	Financial – penalty only	Bottom-up analysis: Although no intervention has been included in the draft determination, further clarifications are required from the company to explain how it has arrived at the weightings between the sub service areas.
Operations which are environmentally sustainable	Leakage (South Staffordshire region)	Financial – reward and penalty	Horizontal check: The reward deadband has been reduced and the penalty collar increased.
	Leakage (Cambridge region)	Reward and penalty	Horizontal check: The reward deadband has been reduced and the penalty collar increased.
	Water efficiency programme	Non-financial incentive	Bottom-up analysis: By agreement with the company, the performance commitment has been moved to the household retail control.
	Biodiversity activity	Non-financial incentive	No Intervention
	Carbon emissions from power consumption	Non-financial incentive	No Intervention

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
Fair customer bills and fair investor returns	Independent customer surveys of value for money and affordability	Non-financial incentive	No Intervention
	Support for customers in debt	Non-financial 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 -20 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 Staffordshire 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 the December plan, South Staffordshire Water proposed wholesale water totex of £401 million over 2015-20. This increased to £411million in the June plan. We calculated the draft determination threshold at £399 million, giving rise to a difference of £12.5 million or 3%. We did consider making further 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 the [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 1.5%.

The proposed wholesale water allowed expenditure for South Staffordshire 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 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						398.6
Costs excluded from menu						14.8
Menu cost baseline ¹	76.2	76.9	77.2	77.3	76.3	383.9
Company's view of menu costs ²						396.3
Implied menu choice						103.2
Allowed expenditure from menu	76.8	77.5	77.8	78.0	76.9	387.0
Costs excluded from menu	3.0	2.9	2.9	2.9	2.9	14.8
Total allowed expenditure ³	79.8	80.5	80.8	80.9	79.8	401.8

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015- 20
Less pension deficit repair allowance	1.4	1.4	1.4	1.4	1.4	6.8
Totex for input to pay as you go (PAYG)	78.4	79.1	79.4	79.5	78.5	395.0

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: PAYG and 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 Staffordshire Water wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£m)	78.4	79.1	79.4	79.5	78.5	395.0
PAYG %	67.7%	67.6%	67.7%	67.9%	68.3%	67.9%
Resulting PAYG (£m)	53.1	53.5	53.8	54.0	53.6	268.0

Table A2.4 shows the regulatory capital value (RCV) run-off amounts included within the wholesale water charge. This reflects a run-off rate of 6.00% for the RCV as at 31 March 2015 and 13 years for the totex additions to the RCV over 2015-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Run-off of 2015 RCV	18.8	17.9	16.6	14.8	13.6	81.7
RCV run-off of totex additions	1.0	3.0	5.1	7.1	9.1	25.3
Total RCV run-off	19.8	21.0	21.6	21.9	22.7	107.0

A2.2.3 Return on the RCV

The company has asked for a company specific uplift of 0.40% of the wholesale weighted average cost of capital (WACC) of 3.70% set out in the [risk and reward guidance](#). We have considered whether this it would be appropriate to allow for this uplift based on the approach we set out in our risk and reward guidance:

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

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

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

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

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

We have therefore used a wholesale water cost of capital of 3.70% in this draft determination. This results in a return on capital of £60 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 Staffordshire Water wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	326.2
Land sales	-1.2
Adjustment for actual expenditure 2009-10	-0.9
Adjustment for actual expenditure 2010-15 ¹	-11.0
Net adjustment from logging up, logging down and shortfalls	0.0
Other adjustments	0.0
Opening RCV 1 April 2015	313.0

Note:

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

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

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	313.0	318.5	323.1	327.1	330.8
RCV additions (from totex)	25.3	25.6	25.6	25.6	24.8
Less RCV run-off	19.8	21.0	21.6	21.9	22.7
Closing RCV	318.5	323.1	327.1	330.8	333.0
Average RCV (year average)	315.8	320.8	325.1	329.0	331.9
Return on capital	11.7	11.9	12.0	12.2	12.3

A2.2.4 Reconciling 2010-15 performance

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

The company proposed adjustments to the opening RCV and allowed revenue for the wholesale water services to reconcile performance in 2010-15. We have intervened and as a result the revenue adjustments for wholesale water have changed from: £15.4 million to £14.1 million. We summarise these interventions in Table A2.7 below, and quantify the resulting adjustments within this draft determination.

The impact on the opening RCV of 2010-15 adjustments is shown in Table A2.5 and we discuss our interventions in this area further in annex 3.

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

Area	Intervention	Why we did it	Total 2010-15
Service incentive mechanism (SIM)	There are no interventions in this area	n/a	2.8
Revenue correction mechanism (RCM)	<p>We have intervened in the following areas.</p> <ul style="list-style-type: none"> • Back billing • Forecast 2014-15 tariff basket revenue • FD09 assumptions • Outturn financial year average RPI • Corporation tax rate 	<p>We have concerns as to whether the back billing amounts are compliant with RAG4.04 and IN11/04 and so have disallowed these amounts.</p> <p>We also have concerns on the company's forecast 2014-15 tariff basket revenues, PR09 final determination assumptions, and application of tax rates and consider there are some data inconsistencies. We expect the company to address these issues in its representations.</p>	10.6
Opex incentive allowance (OIA)	There are no interventions in this area.	n/a	4.9
Capital expenditure incentive scheme (CIS)	In assessing South Staffordshire's CIS feeder model, we made a corrective adjustment for the PR09 final determination error with the FBP (bid) MNI grants and contributions values.	The company's CIS feeder model does not contain a corrective adjustment for the PR09 final determination error with the final business plan (bid) MNI grants and contributions.	-4.3

Area	Intervention	Why we did it	Total 2010-15
Other adjustments	There are no interventions in this area.	n/a	0
Total	n/a	n/a	14.1

A2.2.5 Calculation of allowed revenue

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

Overall, we consider that the company's wholesale water revenue allowance should be £94.4 million in 2015-16, decreasing by 2.9% to £91.7 million in 2019-20.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex	78.4	79.1	79.4	79.5	78.5	395.0
PAYG ratio	67.74%	67.63%	67.72%	67.87%	68.35%	-
Totex additions to the RCV	25.3	25.6	25.6	25.6	24.8	126.9
RCV (year average)	315.8	320.8	325.1	329.0	331.9	-
Wholesale allowed revenue build up:						
PAYG ¹	54.5	54.9	55.1	55.3	55.0	274.8
Return on capital	11.7	11.9	12.0	12.2	12.3	60.0
RCV run-off	19.8	21.0	21.6	21.9	22.7	107.0
Tax ²	1.6	2.2	2.0	2.1	2.2	10.1
Income from other sources	-1.6	-1.6	-1.6	-1.6	-1.6	-8.1
Reconciling 2010-15 performance	1.5	3.8	3.1	3.1	2.7	14.1

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Ex ante additional menu income	-0.3	-0.3	-0.3	-0.3	-0.3	-1.6
Wholesale allowed revenue adjustments						
Equity Issuance Cost	0.0	0.0	0.0	0.0	0.0	0.0
Revenue solving adjustment	0.0	0.0	0.0	0.0	0.0	0.0
Profiling adjustments ³	5.4	0.0	-0.8	-2.1	-3.1	-0.6
Capital contributions from connection charges and revenue from infrastructure charges	1.9	1.9	1.9	1.9	1.9	9.3
Final allowed revenues	94.4	93.7	93.0	92.3	91.7	465.0

Notes:

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

A2.3 Uncertainty mechanisms

We outline our approach to uncertainty mechanisms in the [risk and reward technical appendix](#). In Table A2.9 below, we set out South Staffordshire Water's proposed wholesale water uncertainty mechanisms and our assessment of these proposals.

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

South Staffordshire Water’s proposals	Our assessment
<p>South Staffordshire Water proposed an uncertainty mechanism for water business rates with a sharing rate of 75% customer and 25% company.</p>	<p>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 appendix.</p>

A3. Household retail

A3.1 Company outcomes, performance commitments and delivery incentives

In the [outcomes technical appendix](#), we discuss our approach to outcomes for the wholesale and retail controls.

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

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

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

Company proposal			Intervention
Outcome	Performance commitment	Incentive type	
An excellent customer experience to customers and the community	Service incentive mechanism (SIM)	Financial – Reward and Penalty	No Intervention
	Customer satisfaction from independent surveys (not SIM)	Non-financial incentive	No Intervention
	Community activity and engagement with customers	Non-financial incentive	No Intervention

A3.1.1 Outcome delivery and reporting

In the [assurance technical appendix](#), we set out our proposed framework for the form and level of reporting, monitoring and assurance we will seek from companies during the five year regulatory period 2015 -20 in relation to the delivery of their commitments for the price review. This sets out three levels of assurance and the opportunities available for a company to improve its category status through the finalisation of the price controls and during the regulatory period itself.

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

South Staffordshire 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 Staffordshire Water’s cost allocation methodology.

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

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

We will use the company’s costs to set our draft determination. However, we noted the following issues with respect to the company’s cost allocation:

- the company has not allocated most of its doubtful debt charge in line with our guidance (only unmeasured debt over 5 years old and measured debt over 4 years old has been allocated in accordance with our guidance);
- the company has not allocated services to developers, disconnection costs, insurance and power and fleet service between retail and wholesale in accordance with our guidance;
- the company has not stated how it has allocated demand-side water efficiency between retail and wholesale;
- the company has included a cost of £134k relating to Creative Studio in retail, we do not know what this cost relates to and cannot therefore confirm that it is an appointed activity and that it has been correctly allocated to retail; and
- the company has not stated how it has allocated facilities and grounds maintenance and IT costs between household and non-household.

We also 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 a UKGAAP rather than on an IFRS basis.

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

- the results of an exercise which we expect the company to undertake to cross check its current allocation of the doubtful debt charge against an allocation based on debt written off (that is, how different would the allocation be between household and non-household based on debts written off in 2013-14);
- revised tables R3 and R4 prepared on an IFRS basis will the allocations noted above corrected and, where necessary, clarified;
- the detailed cost allocation tables for 2013-14 for retail / wholesale and household / non-household to support the revised figures in lines 1 of R3 and R4; and
- 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 for the October submission.

A3.2.2 Adjustments

In Table A3.2 below, we outline South Staffordshire Water's proposed ACTS adjustments and our assessment of these proposals.

Table A3.2 South Staffordshire 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
Bad debt	4.2	Pass	Fail	Fail	Fail
Input price pressure	6.0	Pass	Fail	Efficiency benchmarking evidence: Fail	Fail
				Upper quartile: Fail	

Bad debt

South Staffordshire Water sought an ACTS adjustment for bad debt based on deprivation and bill size. The total value of the adjustment was £4.2m. This is higher than the £3.7m sought by South Staffordshire Water in its original business plan submission.

We reject South Staffordshire Water's proposal for an average cost to serve (ACTS) adjustment for bad debt based on deprivation and bill size.

Although South Staffordshire Water's adjustment is material and it submitted updated modelling analysis in support of its adjustment claim, this did not provide sufficient and convincing evidence to justify the adjustment value sought.

In addition, the evidence on South Staffordshire Water's levels of deprivation compared to other companies is somewhat mixed – South Staffordshire Water has above average deprivation when measured by the Index of Multiple Deprivation (IMD) and the income domain of the IMD, but below average deprivation when measured by the 10% most deprived households and by the Experian deprivation index used by Dŵr Cymru Water. South Staffordshire Water also has the second lowest bills in the country. Consequently, when taken in the round, this evidence does not demonstrate in a consistent and convincing manner that deprivation and bills affect South Staffordshire Water in a materially different way to other companies.

Overall, South Staffordshire Water failed to provide robust and conclusive quantitative evidence to justify the value of its proposed adjustment and, hence, this evidence does not support an ACTS adjustment for bad debt.

Input price pressure

South Staffordshire Water proposed an adjustment for Input Price Pressure (IPP) for £6.0m over 2015-20, or £5.6m after £0.36m for bad debt inflation is removed as it is presented in parts of the company's business plan.

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

The value of the adjustment is material, at 6.7% of household retail operating expenditure plus depreciation over 2015-20.

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

The evidence provided on benchmarking of relative efficiency shows that South Staffordshire Water's Walsall/Echo service centre business is efficient, but its Cambridge service centre is less so. South Staffordshire Water provided insufficient evidence to explain why maintaining two service centres is efficient. We do not consider this to be sufficient evidence to demonstrate that South Staffordshire Water is an efficient retailer compared to companies outside of the water industry.

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. 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.

Although we do not consider that an adjustment for input price pressure is appropriate for South Staffordshire Water, for completeness we have assessed the evidence provided on the size of an adjustment. South Staffordshire Water has considered evidence on inflation relevant to a number of cost areas. However, its estimates of wage inflation appear high in comparison to estimates from other

companies, and so we conclude that the wage inflation included in the construction of their claim is not appropriate for the water retail sector.

Table A3.3 Household retail adjustments (£ million, nominal prices)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Adjustments proposed in South Staffordshire Water's business plan						
Bad and doubtful debt	0.848	0.824	0.824	0.848	0.872	4.215
Input price pressure	0.534	0.780	1.142	1.570	1.960	5.986
Pension deficit repair costs	0.291	0.291	0.291	0.291	0.291	1.454
Adjustments included in business plan	1.672	1.894	2.257	2.709	3.123	11.656
Adjustments included in draft determination						
Bad and doubtful debt	0.000	0.000	0.000	0.000	0.000	0.000
Input price pressure	0.000	0.000	0.000	0.000	0.000	0.000
Pension deficit repair costs	0.288	0.288	0.288	0.288	0.288	1.439
Adjustments included in draft determination	0.288	0.288	0.288	0.288	0.288	1.439

Note:

There will be no indexation for retail price controls.

A3.2.3 New costs

In Table A3.4 below, we outline South Staffordshire Water's proposed 'new costs' and our assessment of these proposals. The new costs included in this draft determination are quantified in Table A3.4 below.

Table A3.4 South Staffordshire Water proposals for household retail new costs

Value (£m over 2015-20)	New costs assessment criteria				
	Materiality	Need	Options and CBA	Robustness of costs	Customer protection
3.2	Pass	Fail	Fail	Fail	n/a

South Staffordshire Water's new costs are material (3.6% of total household retail operating expenditure plus depreciation, over 2015-20).

South Staffordshire Water provided some limited evidence on the need for the new costs. The evidence around the need for the two largest investments – customer service improvements and vehicles is not sufficiently explained.

Cost benefit analysis was referenced for some costs, but was not provided. Options analysis was referenced in some cases, but not provided. We have therefore not been able to assess the quality of this evidence.

There was no evidence that the costs had been market tested or otherwise shown to be robust.

These costs are linked to outcomes, which provides some evidence that customer protection has been considered. The SIM will provide some protection to customers. The risk of customers funding investments that are not made is lower for South Staffordshire Water than for other companies as a significant proportion of the investments are underway and are being made in the previous price control period 2010-15. These investments are nevertheless considered to be new costs because the depreciation occurs over 2015-20. As the risk of non-delivery is low, so we are satisfied that customer protection has been sufficiently considered.

In summary, for the reasons set out above, we reject South Staffordshire Water's proposed new costs. All new costs above the materiality threshold are excluded from the calculation of allowed revenues. The evidence base supporting new costs is considered to be neither sufficient nor convincing. The need for the new costs is not justified, the costs have not been shown to be the most cost beneficial means of meeting the need, and the costs are not shown to be robust.

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

	Value
Modification made to 2013-14 CTS for ACTS calculation	0.58

Note:

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

A3.3 Calculating the allowed revenues

Using the average industry allowances per customer, and the projected customer numbers in the company's revised business plan, we have calculated the total

allowed household retail revenues, including the efficiency challenge and the household retail net margin.

A3.3.1 Net margins

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

Table A3.6 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	23.11					
Metered water only customers	26.14					
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		19.33	19.16	19.34	19.98	20.77
Metered water only customers		22.35	22.18	22.36	23.00	23.79
Total allowed (£ million)						
Cost to serve (excluding net margin)		13.5	13.5	13.7	14.2	14.9
Forecast household wholesale charge (including forecast RPI ²) ³		101.4	104.0	106.9	109.6	112.1
Household retail revenue (including an allowance for the net margin) ⁴		14	14	15	15	16

Notes:

There will be no indexation for retail price controls.

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

A3.4 Uncertainty mechanisms

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

Table A3.7 South Staffordshire Water's proposals for household retail uncertainty mechanisms

South Staffordshire Water's proposals	Our assessment
South Staffordshire 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 the non-household retail price controls is set out in 'IN14/14: 2014 price review – non-household customer engagement ahead of draft determination representations'.

In this chapter, we provide details of South Staffordshire 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	2.4	2.4	2.4	2.3	2.3

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.

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

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

This resulted in the company's proposals being adjusted from £0.248 million over the control period, to £0.231 million.

In total, this resulted in the company's proposed costs being adjusted from £8.561 million over the 2015-20 to £8.544 million.

We note that from 2013-14 through to 2019-20 the company is proposing cost reductions of 14%. This is significantly greater than the proposed reduction for the household control. As part of its representations we expect the company to provide us with a clear explanation as to why it expects much higher cost reductions for its non-household retail activities than its household.

However, we also note that the company's opex in 2013-14 is significantly higher than the preceding three years. As part of its representations we expect the company to provide us with a clear explanation as to the cost increase, and to explain why the increase should not be treated as an exceptional one-off event.

A5. Appointee

In this section we discuss at an appointee level:

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

A5.1 Bills and K factors

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

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water – allowed revenues (£m) ¹	94.4	93.7	93.0	92.3	91.7	465.0
Wholesale water – K (%) ²	0.00%	-0.72%	-0.62%	-0.91%	-0.91%	-
Retail household allowed revenue (£m)	14	14	15	15	16	75
Retail non-household expected revenue (£m)	2	2	2	2	2	12
Average household bill – water (£) ³	130	129	128	128	128	-

Notes:

A Wholesale figures in 2012-13 prices and retail figures in nominal prices

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

We note that customer bills in the regulatory period from 2020 will be affected by South Staffordshire 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 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 Staffordshire Water, and reflecting our interventions on ODIs, is shown in Table A5.2 below.

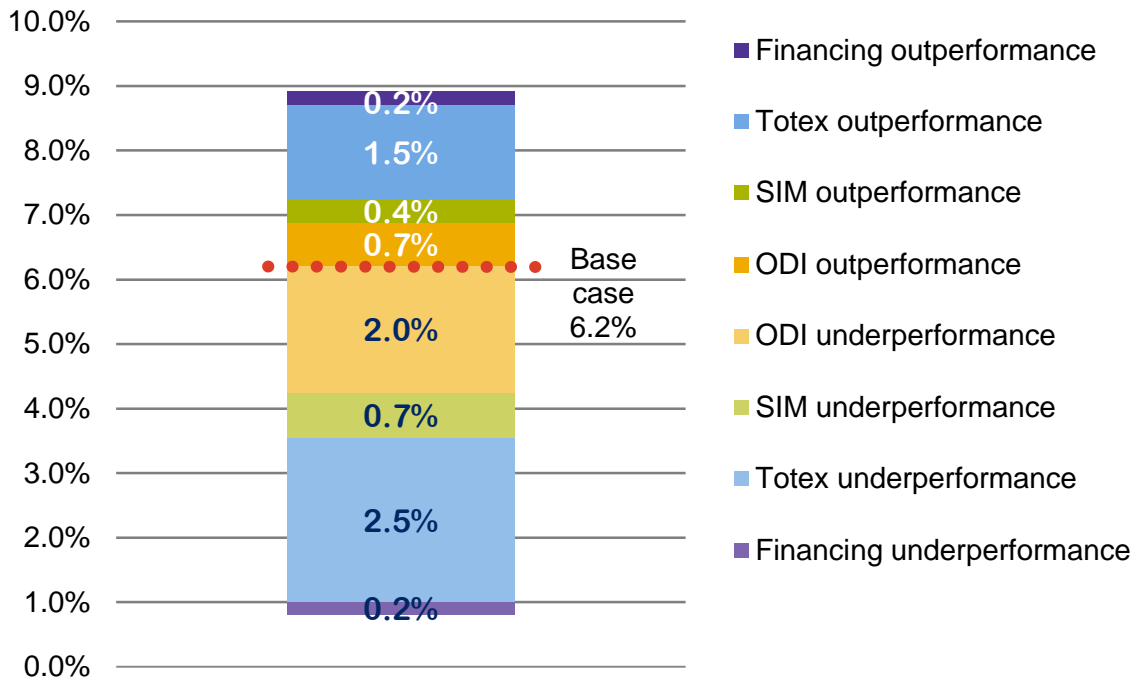
Table A5.2 Whole Company RoRE range

	Lower bound (%) (appointee)	Upper bound (%) (appointee)
Overall	-5.4%	+2.7%
ODIs	-2.0%	+0.7%
Totex	-2.5%	+1.5%
Financing	-0.2%	+0.2%
SIM	-0.7%	+0.4%

	Lower bound (%) (appointee)	Upper bound (%) (appointee)
<p>Commentary:</p> <p>The whole company RoRE range is from 0.8% to 8.9%, with a base case of 6.2%. This translates to a downside impact of -5.4% and an upside variance of +2.7% as shown in the table.</p> <p>Cost performance variance has been modelled by South Staffordshire Water by combining the external risk scenarios, using predominantly PwC forecasts, with its view of uncontrollable movements. The resultant RoRE impacts ranging from -2.5% to +1.5% are consistent with other companies and considered to be acceptable.</p> <p>The ODI range proposed by South Staffordshire Water was from -1.0% to +1.0%. We have adjusted this range to -2.0% to +0.7% to take account of our interventions discussed in annex 4.</p> <p>South Staffordshire Water has modelled financing risk on a notional basis applying a variation of +/- 50 basis points to the cost of new debt which results in a RoRE range of -0.2% to +0.2%. We consider this to be reasonable.</p> <p>The SIM range has been assessed using the full range of rewards and penalties (-1% to +0.5% of revenue) reflecting South Staffordshire Water's view that, on a P10/P90 basis, any ranking is possible given the uncertainty about the performance of the industry over the next five years and the company's relative performance. We accept the company's rationale.</p>		

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

Figure A5.1 South Staffordshire Water’s RoRE range – appointee



Source:

Ofwat calculations based on information from South Staffordshire Water

A5.3 Financeability

We have compared the financial ratios provided by South Staffordshire Water and our calculation of its financial ratios implied by the company’s June business plan, on a notional basis. We illustrate these in Table A5.3 below. The final column of Table A5.3 sets out the financeability ratios based on our draft determination revenues and costs.

Table A5.3 Company and Ofwat 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)	3.18	3.34	3.59
Adjusted cash interest cover ratio (ACICR) – base case (avg over five years)	1.37	1.42	1.46
Funds from operations(FFO)/debt	12.28%	12.35%	12.25%
Retained cash flow/debt	9.68%	9.68%	9.67%
Gearing	66.17%	66.66%	66.93%
Dividend cover (profit after tax/dividends paid)	1.62	1.52	1.56
Regulatory equity/regulated earnings for the regulated company	8.53	15.02	15.43
RCV/EBITDA	8.26	8.29	8.57

Commentary:

Financial ratios: South Staffordshire Water's target credit rating is BBB+. Its ratios appear to be generally consistent with its target rating, although its AICR may be marginally below published rating agency guidance. It has stronger FFO/debt and ICR ratios. Our calculated ratios are higher for both the company's business plan and the draft determination. On this basis we consider that the draft determinations are financeable on a notional basis.

Use of PAYG: South Staffordshire Water has not materially changed PAYG since December and does not appear to be bringing revenue forward to 2015-20 since its December business plan. The company is passing through around 100% of its change in WACC from 4.46% to 4.1% in terms of lower customer bills in 2015-20.

Conclusion on intervention: Given the level of these ratios and that the company has not adjusted PAYG since the December submission, we do not intend to intervene on the basis of financeability or PAYG. However we identified issues with the financial data provided by South Staffordshire Water during the review of the company business plan and so we

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	
require the company to provide additional third party assurance on financeability and its calculation of financial ratios in response to the draft determinations.			

Table A5.4 sets out the PAYG and RCV run-off rates which shows if PAYG and RCV run off rates has been adjusted since the December plan and the impact that this has on RCV growth and longer term affordability and financeability.

Table A5.4 Impact on the longer term

	PAYG rate	RCV run-off	RCV growth % 1 April 2015 to 31 March 2020
Company December plan	69.06%	5.87%	7.6%
Company June plan	67.86%	5.87%	7.4%
Draft determination	67.9%	5.87%	6.4%

A5.4 Affordability

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

Table A5.5 Household bill profile

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Company December plan	136	136	136	136	136	136
Company June plan	136	136	136	135	135	135
Ofwat calculation for draft determinations – pre-reprofiling	133	123	129	129	131	132

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Ofwat calculation for June plan	133	130	136	137	139	141
Ofwat calculation for draft determinations	133	123	129	129	131	132

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 A5.5) are not directly comparable to the company plans (lines 1 and 2 of Table A5.5). Our interventions have reduced revenue and bill requirements over 2015-20. In the absence of customer preferences for bill profiles at this level we have reprofiled bills so that there is a reduction in the first year with broadly flat bills for the remainder of the period. This equalises the customer benefits across the period and avoids a large drop in bills in 2015-16, with a subsequent increase in the following years. We invite South Staffordshire Water to engage with its customers on the priorities for bills as part of its response to the draft determinations.

Table A5.6 sets out the reasons why this draft determination is assessed as affordable. It describes key changes in relation to the company's December business plan that we concluded was not demonstrably affordable to its customers.

Table A5.6 Business plan affordability assessment

	Commentary
Acceptability	<p>The company failed the RBR affordability test as we concluded it had not demonstrated its plans were affordable to its customers during 2015-20. The company conducted customer research to support its original December 2013 business plan submission but its research tested a 2% bill increase and found only 59% of customers found this acceptable when they were asked about bills including inflation. We concluded that it was not clear if the company's proposal for flat real terms bills had been adjusted sufficiently to improve the affordability of its plan.</p> <p>The company has retested its plan. This research provided acceptable descriptions of inflation when asking respondents about acceptability. Overall 87% of customers agreed the company's plan for marginally decreasing real term bills was acceptable and a similarly high 86% of the lower Socio</p>

	Commentary
	<p>Economic Groups (group DE) also found the plan acceptable.</p> <p>Overall, we have concluded that the company has taken a robust approach to testing its June submission proposals, established that a majority of its customers find its proposals acceptable, and clearly identified a proportion of customers who struggle to afford their water bills.</p>
Identification of affordability issues and appropriate support measures	<p>In its December submission, the company proposed an appropriate range of measures designed to help those customers identified as having affordability problems including a group wide investment in supporting and extending the company's charitable trust fund by £1m and a commitment to develop a social tariff providing customer support is forthcoming.</p> <p>There is no evidence from the company that it is planning to alter its original submission's proposals to provide measures to ensure the affordability of its bills in 2015-20. These activities form a key part of our assessment of what makes the company's plan affordable and therefore should not be seen as discretionary.</p>
Longer-term affordability– cost recovery tools	<p>The company has not altered its RCV run-off rate from its December 2013 submission. Only minor adjustments have been made to the PAYG ratio with no significant changes to the rates in 2020-25.</p> <p>Consistent with our original assessment there is therefore sufficient and convincing evidence that the company's use of cost recovery tools will not adversely affect current or future affordability.</p>
Longer-term affordability – ODIs	<p>The company's CCG concluded that the overall acceptability of the revised Business Plan to customers was not compromised by the introduction ODIs of the scale proposed in its June submission. If maximum ODI rewards were achieved they would be unlikely to significantly impact on overall acceptability as our analysis shows that the company's proposal could lead to an addition of around £1 to average household bills if the maximum rewards were achieved.</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 the draft determination initial cost threshold model](#).

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
356.8	41.2	-2.9	3.5	398.6	4

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
26.0	6.8	7.9	0.5	0.0	41.2

Note:

1. Of this amount, £0.072m 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
411.1	398.6	12.5	29.1

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
MNI – Safeguarding Supplies	£15.2	£13.5	n/a	n/a	n/a	Reject	-
Supply demand Balance	£17.7	£5.1	Pass	Pass	n/a	Partially Accept	£3.5
Model representations¹ – power costs	£14.8	£13.2	n/a	n/a	n/a	Reject	-
Traffic Management Act – permit Charges	£2.4	£2.1	n/a	n/a	n/a	Reject	-

In its June submission the company also included a claim that the full and refined totex models don't forecast sufficient expenditure to take account of their significant enhancement programme. Our analysis and conclusions on this claim have been set out in annex 1 to the [wholesale water and wastewater technical appendix](#).

Annex 2 Household retail revenue modification

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

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

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

Revenue modification per:	2015-16	2016-17	2017-18	2018-19	2019-20
Unmetered water only customer	20.64	20.50	20.71	21.38	22.21
Metered water only customer	23.87	23.73	23.94	24.62	25.44

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	382.2	373.8	365.3	356.9	348.5
Metered water only	272.1	284.3	296.6	309.1	321.7

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 Staffordshire 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)	2.850	2.831
Revenue correction mechanism (RCM)	12.831	10.600
Opex incentive allowance – post-tax (OIA)	3.920	4.939
Capital expenditure incentive scheme (CIS)	-4.171	-4.257
Tax refinancing benefit clawback	0.000	0.000
Other tax adjustments	0.000	0.000
Equity injection clawback	0.000	0.000
Other adjustments	0.000	0.000

	Company view	Ofwat view
Total wholesale legacy adjustments	15.431	14.113

Notes:

*The company resubmitted its OIA data as part of a query response at £4.939m

Totals may not add up due to rounding.

For the CIS mechanism, there is a corresponding adjustment to the RCV made at 1 April 2015 (part of the 'midnight' adjustments'). The impact on the RCV for water can be seen in Table AA3.17. 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 our [wholesale water and wastewater technical appendix](#).

Table AA3.2 provides the annualised rewards from the company's SIM performance. The slight difference in views is due to rounding.

Table AA3.2 SIM annualised rewards (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Company view	0.57	0.57	0.57	0.57	0.57	2.85
Ofwat view	0.566	0.566	0.566	0.566	0.566	2.831

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 Staffordshire 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	2.566	2.566	2.566	2.566	2.566	12.831
Ofwat view	2.120	2.120	2.120	2.120	2.120	10.600

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

Area of intervention	What we did	Why we did it
Backbilling amounts	We have not included the back billing amounts proposed by the company.	<p>We have concerns as to whether the back billing amounts proposed by the company 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 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. • it has taken a reasonable, fair and appropriate approach
Forecast 2014-15 tariff basket revenue	We have restricted the revenue shortfall in 2014-15 to the level recorded in 2013-14.	The company did not explain the reasons for a widening difference between its 2014-15 forecasted revenue and its FD09 revenues forecast compared to variances seen in 2013-14 and earlier years.
FD09 assumptions	We have applied our view of the FD09 assumptions.	The company has not used the FD09 assumptions in its populated RCM model.
Outturn financial year average RPI	Our assumptions for the outturn financial year average RPI at the draft determination use the data the company has submitted in business plan table A9 to calculate our view of the RCM adjustment.	There are inconsistencies with the outturn financial year average RPI between table A9 and the company's populated RCM model.

Area of intervention	What we did	Why we did it
Corporation tax rate	Our assumptions for the corporation tax rate applied in the RCM model at the draft determination is the same as HMRC's published tax rates for each year.	The company has applied a corporation tax rate of 28% across all years in its populated RCM model. Our assumptions for the corporation tax rate applied in the RCM model at the draft determination is the same as HMRC's published tax rates for each year.

Operating expenditure incentive allowance (OIA)

Table AA3.5 below summarises the company's view and our view of the incentive allowances for 2015-20. Table AA3.4 summarises our interventions in relation to South Staffordshire 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	2.789	0.889	0.122	0.122	0.000	3.920
	Ofwat view	3.057	1.143	0.370	0.370	0.000	4.939

*The company resubmitted its OIA data as part of a query response at £4.939m

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

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

Change protocol (logging up, logging down and shortfalls)

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

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

Table AA3.9 summarises our interventions in relation to South Staffordshire 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	0.0	0.0
Logging down	0.0	0.0
Shortfalls	0.0	0.0
Shortfalls for serviceability	0.0	0.0

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

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

Service standard outputs

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

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

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

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

Serviceability performance

Table AA3.10 below summarises our serviceability assessments for South Staffordshire Water and Table AA3.11 quantifies the value and impact of any

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

serviceability shortfall on the RCV. Table AA3.12 summarises our interventions in relation to South Staffordshire 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	Stable	Stable	Stable	Stable
Water non infrastructure	Company view	Stable	Stable	Stable	Stable	Stable
	Ofwat view	Stable	Stable	Stable	Stable	Stable

Notes:

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

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

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

Table AA3.12 Interventions on proposed 2010-15 serviceability adjustments²

Area of intervention	What we did	Why we did it
Water treatment works coliform 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 has had one breach of the upper control limit in 2012-13 and two years above the reference level. 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
Unplanned interruption to supply exceeding 12 hours	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 expect the company to demonstrate its latest performance as part of its representations and in advance of the final determination.	The company has had one breach of the upper control limit in 2013-14. In the Cambridge region, there have been two breaches of the upper control limit in 2010-11 and 2012-13. The performance has improved for the Cambridge region 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

² The shortfall calculation methodology is detailed within our [wholesale water and wastewater appendix](#).

The 2009 agreed overlap programme

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

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

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

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

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

Capital expenditure incentive scheme (CIS)

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

Table AA3.15 Legacy true-up adjustments

		Water service South Staffordshire	Water service Cambridge	Water service Total
Restated FD09 CIS bid ratio	Company view	106.883	101.174	-
	Ofwat view	104.365	101.174	-
Outturn CIS ratio	Company view	100.840	99.820	-
	Ofwat view	100.518	99.538	-
Incentive reward/penalty (%)	Company view	-0.342	0.049	-
	Ofwat view	-0.416	0.132	-
Reward/penalty (£m)	Company view	-0.465	0.015	-0.449
	Ofwat view	-0.568	0.041	-0.526
Adjustments to 2015-20 revenue (£m)	Company view	-2.387	-1.784	-4.171
	Ofwat view	-2.505	-1.752	-4.257
CIS adjustment to RCV (£m)	Company view	-9.170	-1.870	-11.040
	Ofwat view	-9.171	-1.869	-11.039

Commentary:

The figures shown in this table are the aggregate of the South Staffordshire Water assessments.

The company's CIS feeder model for South Staffordshire does not contain a corrective adjustment for the PR09 final determination error with the final business plan (bid) MNI grants and contributions.

In assessing South Staffordshire's CIS feeder model, we made a corrective adjustment for the PR09 final determination error with the FBP (bid) MNI grants and contributions values.

For both CIS models submitted by the company:

- We have used the values submitted in table A9 in the CIS model.
- We have used the values submitted in table W15 in the CIS model.

Notes:

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

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

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

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

		2015-16	2016-17	2017-18	2018-19	2019-20	Total
South Staffordshire	Company view	-2.387	0.000	0.000	0.000	0.000	-2.387
Cambridge	Company view	-1.784	0.000	0.000	0.000	0.000	-1.784
South Staffordshire Cambridge	Ofwat view	-4.257	0.000	0.000	0.000	0.000	-4.257

Other adjustments

Table AA3.19 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 AA3.17 Other adjustments 2015-20 (£ million)

	Company view	Ofwat view	Commentary
Tax refinancing benefit clawback	0.00	0.00	No adjustment was proposed by the company
Other tax adjustments	0.00	0.00	No adjustment was proposed by the company
Equity injection clawback	0.00	0.00	No adjustment was proposed by the company
Other adjustments	0.00	0.00	No adjustment was proposed by the company

Annex 4 Outcomes, performance commitments and outcome delivery incentives

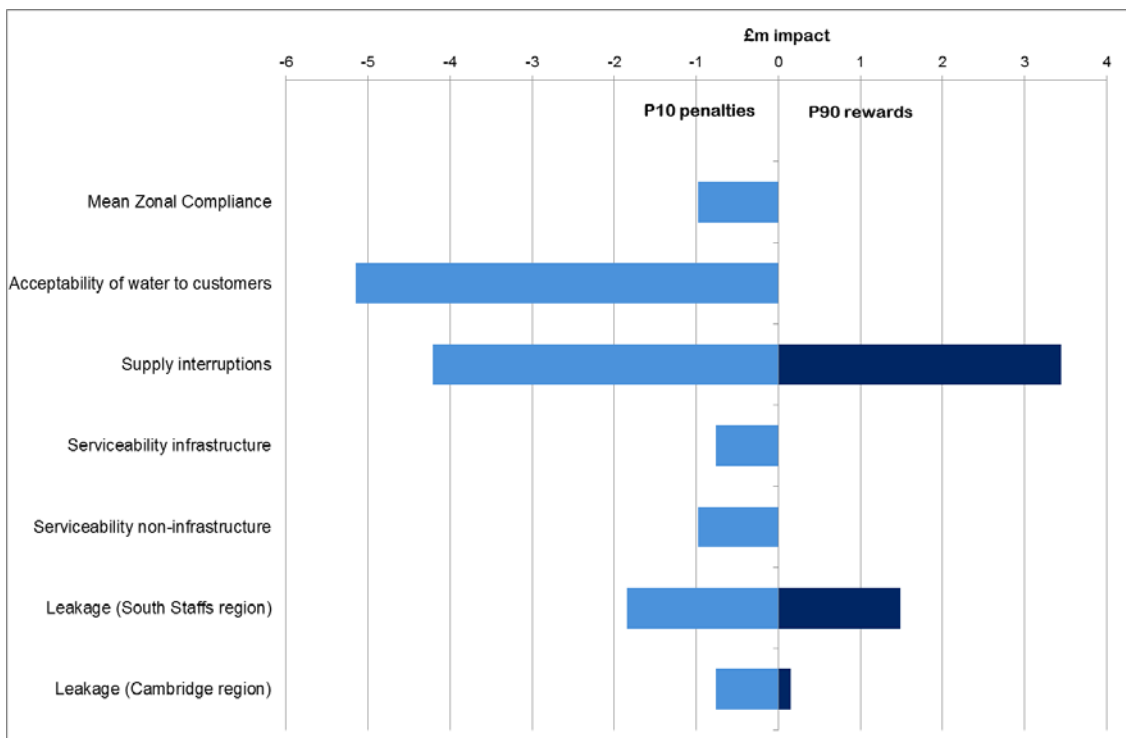
This chapter sets out in detail the performance commitments and outcome delivery incentives (ODIs) for the company’s wholesale water and household retail outcomes, presented in that order.

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 incentives for the company and Figure AA4.2 shows the potential financial impact of each of the financial incentives.

Figure AA4.1 The composition of the package of ODIs

	Reward and penalty	Penalty only	Non-financial incentive
Wholesale water	4	3	7
Household retail	1	0	2
Total	5	3	9

Figure AA4.2 Overview of financial ODIs



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.

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

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

Tables AA4.2 and AA4.3 set out a more detailed explanation of our interventions in the company's wholesale water and household retail outcomes.

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

PC/ODI affected	What we did	Why we did it
1.1 Mean zonal compliance (MZC)	<p>We changed the performance commitment level from 99.97% to 100.00%.</p> <p>We changed the penalty deadband from 99.95% to 99.96%.</p> <p>We changed the penalty collar from 99.92% to 99.93%.</p>	<p>We carried out a horizontal comparison of mean zonal compliance across the industry. This comparison revealed that South Staffordshire Water needs to have a somewhat more stretching performance commitment level, penalty collar and penalty deadband. Consistent with our approach to other companies we have applied these changes for 2017-18 to 2019-20.</p> <p>The company has defined Outcome Delivery Incentives for drinking water quality compliance with a penalty at less than 100%. This penalty represents an incentive to the company to not reduce its compliance with water quality measures. This threshold represents the point at which financial incentives will be applied to the company through the price setting process. All companies are subject to drinking water quality obligations regulated by the DWI,</p>

PC/ODI affected	What we did	Why we did it
		<p>which are the overriding statutory obligations that a water company must comply with as part of their Section 37 obligations. The company's Board has confirmed as part of its business plan submission that it will comply with all relevant statutory obligations.</p>
<p>1.2 Acceptability of water to customers</p>	<p>We reduced the performance commitment level to 1.22 contacts per 1,000 customers from 2017-18 with a glide path from South Staffordshire Water's current performance.</p> <p>We reduced the penalty deadband to 1.22 from 2017-18 with a consequent change to the penalty collar.</p> <p>We reduced the reward deadband to 1.22 in 2015-16 with a consequent change to the reward cap.</p>	<p>We carried out a horizontal comparison of water quality contacts across the industry. This comparison revealed that South Staffordshire Water needs to have a more stretching performance commitment level, penalty deadband, penalty collar, reward deadband and reward cap. Consistent with our approach to other companies we have applied the changes to the performance commitment level, penalty deadband, and penalty collar from 2017-18 to incentivise South Staffordshire Water to achieve upper quartile performance by 2020. We have applied the changes to the reward deadband and reward cap from 2015-16 so that South Staffordshire Water will only earn a reward for upper quartile performance at any point during 2015-20.</p>

PC/ODI affected	What we did	Why we did it
<p>2.1 – Interruptions to supply</p>	<p>We adjusted the penalty rate to equal half of South Staffordshire Water’s average incremental costs.</p> <p>We reduced the penalty deadband to 10 minutes.</p> <p>We reduced the penalty collar to 11 minutes.</p>	<p>Horizontal consistency check/Penalty rate and deadband not sufficiently justified: South Staffordshire Water’s proposed penalty rate was lower than half its average incremental cost. This meant South Staffordshire Water would be better off not delivering any reduction in interruptions. We have increased the penalty rate to equal half of South Staffordshire Water’s average incremental costs to ensure South Staffordshire Water is no better off from not delivering any reductions in interruptions. To avoid disproportionate penalties resulting from this higher penalty rate we have set the penalty collar to make the maximum reward and penalty approximately the same.</p> <p>We carried out a horizontal comparison of interruptions to supply across the industry. South Staffordshire Water is already a relatively high performer, and consistent with our approach to other companies we have set the penalty deadband at 10 minutes to ensure South Staffordshire Water is penalised if it deteriorates from its current performance.</p>
<p>2.2 – Asset serviceability infrastructure</p>	<p>We required South Staffordshire Water to clarify some of the detail underlying its serviceability mechanisms.</p>	<p>Insufficient Information: While South Staffordshire Water has explained its proposed penalties and when they apply to this performance commitment South Staffordshire Water still needs to provide some clarifications on the details of its proposal.</p>
<p>2.3 – Asset serviceability non-infrastructure</p>	<p>We required South Staffordshire Water to clarify some of the detail underlying its serviceability mechanisms.</p>	<p>Insufficient Information: While South Staffordshire Water has explained its proposed penalties and when they apply to this performance commitment South Staffordshire Water still needs to provide some clarifications on the details of its proposal.</p>

PC/ODI affected	What we did	Why we did it
4.1 – Leakage (South Staffordshire region)	<p>We reduce the reward deadband to 66.9 MI/day.</p> <p>We increase the penalty collar from 75.7 to 80.6 MI/day in each year over the next price control period, 2015-20.</p>	<p>Horizontal consistency check/Reward deadband not sufficiently justified: South Staffordshire Water proposed reward deadband is 67.7 MI/day, but South Staffordshire Water has achieved a performance better than that twice in the last 3 years. To ensure that South Staffordshire Water only earns a reward for stretching performance we have reduced the reward deadband to the average of its last 3 years' performance (66.9 MI/day) consistent with our approach to other companies.</p> <p>We carried out a horizontal comparison of leakage across the industry. The comparison identified that the South Staffordshire region leakage penalty range was not sufficiently wide when compared to other companies. We therefore increased the penalty collar from 75.7 to 80.6 MI/day in each year over the next price control period, 2015-20.</p>
4.2 – Leakage (Cambridge region)	<p>Reduce the reward deadband to 12.6 MI/day.</p> <p>Increase the penalty collar from 15.0 to 15.4 MI/day in each year over the next price control period, 2015-20.</p>	<p>Horizontal consistency check/Reward deadband and Penalty Collar not sufficiently justified: South Staffordshire Water's proposed reward deadband is 13.0 MI/day, but South Staffordshire Water has achieved a performance better than that twice in the last 3 years. To ensure that South Staffordshire Water only earns a reward for stretching performance we have reduced the reward deadband to the average of its last 3 years' performance (12.6 MI/day) consistent with our approach to other companies.</p> <p>We carried out a horizontal comparison of leakage across the industry. The comparison identified that the Cambridge region leakage penalty range was not sufficiently wide when compared to other companies. We therefore increased the penalty collar from 15.0 to 15.4 MI/day in each year over the next price control period, 2015-20.</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
There are no interventions for retail outcomes.		

Outcome delivery and reporting

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

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

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

South Staffordshire Water’s proposals	Our assessment
<p>The company’s assurance, transparency, auditing and reporting revolves around annual internal reporting on performance against outcomes, external verification by a credible expert, review and scrutiny by the company’s Board. This in turn will be shared with its customer stakeholder group for further scrutiny before being made publically available. The company is using this approach to ensure that they are both accountable and transparent throughout the next price control period, 2015-20, for the performance commitments they are making. The approach follows six steps:</p> <ol style="list-style-type: none"> 1. Annual reporting of outcomes; 2. Internal review 3. External review by credible expert 4. Board scrutiny 5. Customer stakeholder group review 	<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 Staffordshire Water has provided sufficient evidence demonstrating the approach it will undertake to ensure the PCs will be measured and reported consistently, and the proposed governance and assurance processes. Therefore, we have accepted the company’s proposal.</p> <p>In time, we may develop further information requirements with regard to outcomes, as we review and change current requirements</p>

South Staffordshire Water’s proposals	Our assessment
<p>6. Publicised to customers.</p> <p>The company has designed and developed a reporting scorecard which will be reviewed and improved on prior to the start of the next price control period, 2015-20 and while it is in use during this time. The scorecard will articulate performance and any associated risks while enabling the company’s stakeholders and customers to have an accurate view on company progress through the period.</p> <p>The company is committing to ensuring that the information it reports back to customers and stakeholders is clear and robust and the scorecard will play a large part in that presentation of information.</p>	<p>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 applicable³; and
 - the incentive rates.
- Additional details on the measure.
- where Ofwat has not accepted the company’s proposals, the nature of the intervention made is also explained.

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

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

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 ~~struck through~~. What this means is that we have rejected the proposal that has been struck through and instead we have either used a different value or not included a value at all (for example, in the case of some rewards).

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

Wholesale water outcome 1: Excellent water quality now and in the future

Performance commitment 1.1: Mean zonal compliance (MZC)

Detailed definition of performance measure:

The mean zonal compliance reported annually on a calendar year basis in percent for the combined company.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	99.970	99.970	99.970	99.970 100.000	99.970 100.000	99.970 100.000
Penalty collar	%		99.920	99.920	99.920 99.930	99.920 99.930	99.920 99.930
Penalty deadband	%		99.950	99.950	99.950 99.960	99.950 99.960	99.950 99.960

Incentive rates

Incentive type	Performance levels (%)		Incentive rate (£m/0.01%/year)
	Lower	Upper	
Penalty	99.920 99.930	99.950 99.960	0.065

Additional details

Necessary detail on measurement units

In percent to three decimal places.

Frequency of PC measurement and any use of averaging	Reported annually on a calendar year basis.
Timing and frequency of rewards/penalties	Penalties will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Note that performance is measured in whole percent however South Staffordshire Water's penalty rate is specified per one hundredth of a percent which the company considers is a more appropriate scale for the expected annual variation.

Performance commitment 1.2: Acceptability of water to customers

Detailed definition of performance measure:

The acceptability of water to customers reported annually on a calendar year basis in number per one thousand population, for the combined company.

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	nr/1000	1.83	1.80	1.80	1.80	1.80	1.80
			1.63	1.42	1.22	1.22	1.22
Penalty collar	nr/1000		2.60	2.60	2.60	2.60	2.60
			2.63	2.63	2.02	2.02	2.02
Penalty deadband	nr/1000		2.00	2.00	2.00	2.00	2.00
			1.83	1.83	1.22	1.22	1.22
Reward deadband	nr/1000		1.60	1.60	1.60	1.60	1.60
			1.22	1.22	1.22	1.22	1.22
Reward cap	nr/1000		0.90	0.90	0.90	0.90	0.90
			0.52	0.52	0.52	0.52	0.52

Incentive rates

Incentive type	Performance levels (nr/1,000 population)		Incentive rate (£m/0.1nr/1000 pop/year)
	Lower	Upper	
Penalty	2.00	2.60	0.160
	1.22	2.63	
Reward	0.90	4.60	0.123
	0.52	1.22	

Additional details

Necessary detail on measurement units	In nr/1000 population to two decimal places.
Frequency of PC measurement and any use of averaging	Reported annually on a calendar year basis.
Timing and frequency of rewards/penalties	Penalties and rewards will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	Note that performance is measured in whole numbers however South Staffordshire Water's penalty rate is specified per one tenth which the company considers is a more appropriate scale for the expected annual variation.

Wholesale water outcome 2: Secure and reliable supplies now and in the future

Performance commitment 2.1: Interruptions to supply

Detailed definition of performance measure:

The supply interruptions average duration reported annually on a financial year basis in minutes for the combined company.

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	10.0	10.0	10.0	10.0	10.0	10.0
Penalty collar	Minutes		17.0 11	17.0 11	17.0 11	17.0 11	17.0 11
Penalty deadband	Minutes		13.0 10.0	13.0 10.0	13.0 10.0	13.0 10.0	13.0 10.0
Reward deadband	Minutes		9.0	9.0	9.0	9.0	9.0
Reward cap	Minutes		7.0	7.0	7.0	7.0	7.0

Incentive rates

Incentive type	Performance levels (minutes)		Incentive rate (£m/minute/year)
	Lower	Upper	
Penalty	13.0	17.0	0.076
	10.0	11.0	0.842
Reward	7.0	9.0	0.459

Additional details

Necessary detail on measurement units	In minutes to one decimal place.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	Penalties and rewards will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 2.2: Serviceability infrastructure

Detailed definition of performance measure:

The serviceability assessment category for infrastructure assets assessed on an annual basis for the combined company.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Cat	Stable	Stable	Stable	Stable	Stable	Stable
Penalty collar	Cat		Deteriorating	Deteriorating	Deteriorating	Deteriorating	Deteriorating
Penalty deadband	Cat		Marginal	Marginal	Marginal	Marginal	Marginal

Incentive rates

Incentive type	Performance levels		Incentive rate (£m)
	Lower	Upper	
Penalty rate 1	Marginal	Marginal	0.076 per year
Penalty rate 2	Deteriorating	Deteriorating	0.379 per AMP

Additional details

Necessary detail on measurement units	Categorisation (stable, marginal, deteriorating).
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	Penalties will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	<p>South Staffordshire Water will apply the annual value in penalty rate 1 for each year that its serviceability is marginal. If however South Staffordshire Water's serviceability becomes deteriorating at any point in the AMP then penalty rate 2 supersedes penalty rate 1 and applies once only.</p> <p>The stable, marginal or deteriorating category is determined by a points system relating to the sub-measures. The total points incurred for the basket of sub-measures will be calculated as a 3 year rolling</p>

average and will generate the annual assessment.

Ofwat has not yet approved the full details of the serviceability infrastructure performance commitment. We will clarify the remaining details with the company, specifically how South Staffordshire Water arrived at the weightings between the sub-measures, after the draft determination is published.

Performance commitment 2.3: Serviceability non-infrastructure

Detailed definition of performance measure:

The serviceability assessment category for non-infrastructure assets assessed on an annual basis for the combined company.

Incentive type: Financial – penalty only.

Performance commitments

	Unit	Starting level	Committed performance levels				
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Cat	Stable	Stable	Stable	Stable	Stable	Stable
Penalty collar	Cat		Deteriorating	Deteriorating	Deteriorating	Deteriorating	Deteriorating
Penalty deadband	Cat		Marginal	Marginal	Marginal	Marginal	Marginal

Incentive rates

Incentive type	Performance levels		Incentive rate (£m)
	Lower	Upper	
Penalty rate 1	Marginal	Marginal	0.097 per year
Penalty rate 2	Deteriorating	Deteriorating	0.487 per AMP

Additional details

Necessary detail on measurement units	Categorisation (stable, marginal, deteriorating).
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	Penalties will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	<p>South Staffordshire Water will apply the annual value in penalty rate 1 for each year that its serviceability is marginal. If however South Staffordshire Water’s serviceability becomes deteriorating at any point in the AMP then penalty rate 2 supersedes penalty rate 1 and applies once only.</p> <p>The stable, marginal or deteriorating category is determined by a points system relating to the sub-measures. The total points incurred for the basket of sub-measures will be calculated as a 3 year rolling average and will generate the annual assessment.</p> <p>Ofwat has not yet approved the full details of the serviceability non-infrastructure performance commitment. We will clarify the remaining details with the company, specifically how South Staffordshire Water arrived at the weightings between the sub-measures, after the draft determination is published.</p>

Wholesale water outcome 4: Operations which are environmentally sustainable

Performance commitment 4.1: Leakage SST region

Detailed definition of performance measure:

The total level of leakage, including customer supply pipe leakage, for the SST region reported annually on a financial year basis in MI/d.

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	MI/d	70.5	70.5	70.5	70.5	70.5	70.5
Penalty collar	MI/d		75.7	75.7	75.7	75.7	75.7
			80.6	80.6	80.6	80.6	80.6
Penalty deadband	MI/d		73.3	73.3	73.3	73.3	73.3
Reward deadband	MI/d		67.7	67.7	67.7	67.7	67.7
			66.9	66.9	66.9	66.9	66.9
Reward cap	MI/d		63.3	63.3	63.3	63.3	63.3
			62.5	62.5	62.5	62.5	62.5

Incentive rates

Incentive type	Performance levels (MI/d)		Incentive rate (£m/MI/d/year)
	Lower	Upper	
Penalty	73.3	75.7 80.6	0.369
Reward	63.3 62.5	67.7 66.9	0.186

Additional details

Necessary detail on measurement units	In MI/d to one decimal place.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	Penalties and rewards will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 4.2: Leakage CAM region

Detailed definition of performance measure:

The total level of leakage, including customer supply pipe leakage, for the CAM region reported annually on a financial year basis in MI/d.

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	MI/d	13.5	13.5	13.5	13.5	13.5	13.5
Penalty collar	MI/d		15.0	15.0	15.0	15.0	15.0
			15.4	15.4	15.4	15.4	15.4
Penalty deadband	MI/d		14.0	14.0	14.0	14.0	14.0
Reward deadband	MI/d		13.0	13.0	13.0	13.0	13.0
			12.6	12.6	12.6	12.6	12.6
Reward cap	MI/d		11.5	11.5	11.5	11.5	11.5

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
			11.1	11.1	11.1	11.1	11.1

Incentive rates

Incentive type	Performance levels (MI/d)		Incentive rate (£m/MI/d/year)
	Lower	Upper	
Penalty	14.0	15.4	0.305
Reward	11.1	12.6	0.154

Additional details

Necessary detail on measurement units	In MI/d to one decimal place.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	Penalties and rewards will be applied as a net value at PR19.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 4.3: Water efficiency

Detailed definition of performance measure:

Household per capita consumption (PCC) reported annually on a financial year basis for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	l/h/d	131.44	130.79	130.15	129.52	128.91	128.31

Additional details

Necessary detail on measurement units	In litres per head per day (l/h/d) to two decimal places.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 4.4: Biodiversity

Detailed definition of performance measure:

Cumulative total hectares of land under management per year for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	ha	66	76	91	106	116	116

Additional details

Necessary detail on measurement units	In whole hectares.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 4.5: Carbon emissions from power consumption

Detailed definition of performance measure:

The savings made from our current position above that caused by the reduction in emissions factors (that is, the real savings), in tonnes for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	tCO ₂ e	0	509	1320	2428	3742	5210

Additional details

Necessary detail on measurement units	In tonnes CO ₂ e.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	The performance commitments specified represent the savings made from our current position (hence our current position is referenced as being zero), which are in addition to the savings caused by the reduction in published official emissions factors.

Wholesale water outcome 5: Fair customer bills and fair investor returns

Performance commitment 5.1: Independent customers surveys of value for money and affordability

Detailed definition of performance measure:

The percentage satisfaction in our future surveys on value for money and affordability, for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	87	90	90	90	90	90

Additional details

Necessary detail on measurement units	In whole percent.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 5.2: Support for customers in debt

Detailed definition of performance measure:

The number of customers engaged with on debt (subject to adoption of social tariff), for the combined company.

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	17,000	19,600	22,200	24,800	27,400	30,000

Additional details

Necessary detail on measurement units	In number of customers.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	Our performance commitment for this measure is subject to us gaining customer support to implement a social tariff. In our initial engagement in 2013 sufficient support was not forthcoming. We will however re-engage on the subject.

Household retail outcome 3: An excellent customer experience to customers and the community

Performance commitment 3.1: Service incentive mechanism (SIM)

Detailed definition of performance measure:

SIM is an established industry measure with the parameters of its associated financial incentives being established and controlled by Ofwat. As an industry leading company we have however set our performance commitment at a level that should maintain our strong relative position, as follows:

Incentive type: Reward and Penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Score	88	89	90	90	90	90

Performance commitment 3.2: Customer satisfaction surveys

Detailed definition of performance measure:

The level of customer satisfaction from surveys, in percent, reported annually on a financial year basis for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	%	96	98	98	98	98	98

Additional details

Necessary detail on measurement units	In whole percent.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	None required.

Performance commitment 3.3: Customer engagement**Detailed definition of performance measure:**

The total employee days per year that we spend on community engagement activities, reported annually on a financial year basis for the combined company.

Incentive type: Reputational.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PC	Days	300	400	400	400	400	400

Additional details

Necessary detail on measurement units	In whole days.
Frequency of PC measurement and any use of averaging	Reported annually on a financial year basis.
Timing and frequency of rewards/penalties	n/a
Form of reward/penalty	n/a
Any other information or clarifications relevant to correct application of incentive	None required.

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



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

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