Contents

A1. Overview

This appendix sets out the details of the draft determination of price controls that are specific to Affinity Water (Affinity). On 4 April, we confirmed that Affinity was an enhanced company – this means its business plan is high quality and, as a consequence, the draft determination is largely based on the company's own business plan and forecasts[1]. This will not necessarily be the case for standard companies receiving their draft determinations in June or August as it may be appropriate for us to intervene in these companies' plans if this is necessary to protect customers. In order for the price controls to act to protect the interests of customers, companies must act in an economic and efficient manner in all circumstances. For all avoidance of doubt, this obligation overrides any individual incentive element.

This draft determination sets out the draft allowed revenues and K factors for Affinity, along with what they mean for average customer bills. It also sets out:

- the outcomes we expect Affinity 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 control;
- the adjustments we are making to the wholesale water controls to reflect the company's performance in 2010-15; and
- our assumptions on risk and reward, including the uncertainty mechanisms that form part of each control.

Alongside the reputational and procedural benefits of being enhanced, Affinity will receive a financial benefit of £4 million. This draft determination explains how this financial reward has been incorporated into the draft allowed revenues and K factors for the company (see section 2.2.4).

As part of this 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 controls for wholesale

[1] This includes revised information that the company has provided on legacy adjustments and retail cost allocation in response to the actions identified by us on 10 March. Affinity will supply amended information on retail cost allocation, which is fully compliant with the guidance we published on 24 March, by 27 June.

and retail elements of the appointee business. The draft determinations are therefore structured on an element basis and are separated into wholesale water, household retail and non-household retail.

For the non-household retail control, this document does not set out a draft determination for Affinity's default tariffs. As discussed in 'Draft price control determination notice: technical appendix' (the 'technical appendix') we will be doing this for all companies once they have resubmitted their proposed default tariffs to us. However, it does set out the assumptions we have made about the non-household control for the purposes of assessing the financeability of the appointed business as a whole.

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

The annexes to this document provide more detail on the following areas of our draft determination and with this document form part of the draft price control determination notice.

- Annex 1: Outcomes, performance commitments and outcome delivery incentives.
- Annex 2: Wholesale costs.
- Annex 3: Household retail price control.
- Annex 4: Reconciling 2010-15 performance.

Written representations on this draft determination should be provided to us by 4 June 2014.

A1.1 Bills and K factors

The table below sets out the allowed revenues we have assumed in our draft determination for the company to deliver its outcomes and associated performance commitments. It also sets out the average bills customers will face as a result of the draft determination. The profile of revenue, and therefore average bill, reflects the profile proposed by the company in its revised business plan. The company chose to smooth the profile by adjusting its pay as you go (PAYG) ratio (see section A2.2.3). The PAYG ratio is the proportion of the total expenditure (totex) allowance that will be recovered in period (2015-20). The remainder of the totex allowance is added to the RCV and so will be recovered over future periods. Our draft determination reflects this approach.

Table A1 Affinity Water's draft determination allowed revenues and customers' bills

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water – allowed revenues (real)[1] (£ million)	254.5	256.5	248.3	246.1	245.5	1,251.0
Wholesale water – K (%)	0.00%	1.44%	-2.46%	-0.36%	0.09%	–
Retail household allowed revenue (£ million)	28.1	27.8	27.3	26.7	26.7	136.5
Retail non-household expected revenue[2] (£ million)	4.7	4.7	4.7	4.6	4.6	23.4
Average customer bill (water) (£)	165	165	159	156	155	–

[1]The allowed revenue for our draft determination is based on an implied menu choice. The company will have the opportunity to change its menu choice, which will impact on its allowed revenues and customers' bills.
[2] We have not made a draft determination for the company's non-household retail control. We will do this following the resubmission of proposed default tariffs by companies to us.

A1.2 Community level reporting

Affinity Water has a vision to be the leading community-focused water company and has split its region into eight local communities. To ensure it remains accountable to the communities it serves, it will report its operational performance at a community level. Affinity Water has developed a reporting tool (Navig-8) to reflect unique local issues and report on the condition of local assets. This tool offers communities the ability to view historical service as well as forecasts of expected future performance against levels of investment. Affinity will provide its communities with a clear picture of performance against its commitments within their local area and the ability to compare performance across the eight communities.

A2. Wholesale water

A2.1 Company outcomes, performance commitments and delivery incentives

A2.1.1 The PR14 focus on outcomes

As we set out in our final methodology statement, outcomes are one of the key innovations in PR14. Company business plans have been focused on outcomes rather than outputs. This ensures that companies are incentivised to deliver efficiently what customers and society need, want and are willing to pay for and helps to legitimise their role in providing important public services.

Companies have engaged directly with their customers and customer challenge groups (CCGs) to develop a set of **outcomes**, together with the associated **performance commitments** and **outcome delivery incentives** (ODIs). The performance commitments set out in detail the levels of performance that the companies commit to achieve within the five year period from April 2015 to March 2020. The incentives set out what happens if companies over or under deliver against the committed performance levels.

The creation of delivery incentives directly linked to the outcomes encourages strong performance on a continuous basis. The incentives give the best performing companies the opportunity to earn improved returns from financial rewards where there is evidence customers have indicated their support. The incentives also ensure that customers are protected against poor performance, with less well performing companies held to account where performance falls below the committed performance levels, and where the incentive is financial, paying money back to customers.

Our final methodology statement set out a framework which gives companies a choice of three incentive types (financial rewards and penalties; financial penalty only or reputational) and also considerable flexibility in how the incentive is calibrated. This includes the possibility to use limits on incentives (caps on rewards and collars on penalties) as well as neutral zones or dead bands within which the incentive is 'switched off'. Following our initial review of the companies' business plans, we provided further guidance over the alignment of performance commitments with effective financial incentives in 'Setting price controls for 2015-20 – risk and reward guidance' (our 'risk and reward guidance'). Further details of the approach to outcomes are set out in the technical appendix.

2.1.2 Outcomes, performance commitments and incentives

The outcomes, performance commitments and outcome delivery incentives proposed by the company, and which we are adopting for the wholesale water control are summarised in table A2 below. These reflect the company's own business plan proposals after consultation with its customers and CCG. They include the revisions the company made in response to our risk and reward guidance, following the general principles and process set out in the technical appendix. Annex 1 sets out the detail of the outcomes, performance commitments and incentives that we are consulting on as part of our draft determination.

Table A2 Wholesale water outcomes, performance commitments and incentives

Outcome	Performance commitment	Incentive type
Making sure our customers have enough water, whilst leaving more water in the environment	Leakage	Financial – reward and penalty
	Average water use	Financial – penalty only
	Water available for use	Financial – penalty only
	Abstraction incentive mechanism (AIM)	Reputational
	Sustainable abstraction reduction	Financial - reward and penalty
Supplying high quality water you can trust	Compliance with water quality standards	Financial – penalty only
	Customers contacts about water quality	Financial – penalty only
Minimising disruption to you and your community	Unplanned interruptions to supply over 12 hours	Financial – reward and penalty
	Number of burst mains	Financial – penalty only
	Affected customers not notified of planned interruptions	Reputational (with compensation payments)
	Planned work taking longer to complete than notified	Reputational (with compensation payments)

In its March business plan, Affinity provided further detail on its revised approach towards incentives regarding asset health. It explained that the approach that it had followed was to propose performance commitments covering the delivery of its outcomes and management of its assets that customers had identified as high priority. Some of these commitments were previously measures in the serviceability assessments used during previous price controls.

Affinity explained that three of its performance commitments for leakage, discolouration contacts and mains bursts are directly related to the health of its assets. In addition, the performance commitments for unplanned supply interruptions greater than 12 hours and compliance with water quality standards also indicate the health of the treatment processes and the infrastructure assets related to delivery of potable water. Any deterioration in the performance of these assets would therefore be identified through the reported performance on these measures.

Affinity has also proposed a new measure, water available for use (WAFU). This directly relates to the serviceability of the infrastructure assets since WAFU demonstrates the capacity of the treatment assets to meet customers’ demand, minus any outage due to either planned or unplanned maintenance. Long-term trends in WAFU can therefore demonstrate both availability and reliability of the treatment assets.

To complete the overall picture regarding asset health, Affinity also indicated that any remaining metrics relevant to asset health for which there was not an individual performance commitment would be developed as part of a new asset health index that it plans to introduce. The detailed specification of the index will be developed by the company in discussion with an independent Stakeholder Assurance Panel so that the index is in place before the start of the new price control period in April 2015.

In addition to the specification of the index, Affinity will also identify the levels of performance on the index that it will deliver and the outcomes which these support. Together with the specific established and new performance commitments, this new index will provide additional transparency in the company’s dialogue with its customers at a community level and be reported against on a quarterly basis.

Affinity’s revised approach is in line with our expectations regarding incentives around asset health. The company is taking ownership of its maintenance approach. It is also ensuring that high profile services are visible to customers and have appropriate financial and reputational incentives in place. Affinity will provide further detailed information on its proposals for this index for inclusion in the final determination.

A2.2 Calculating the wholesale water control

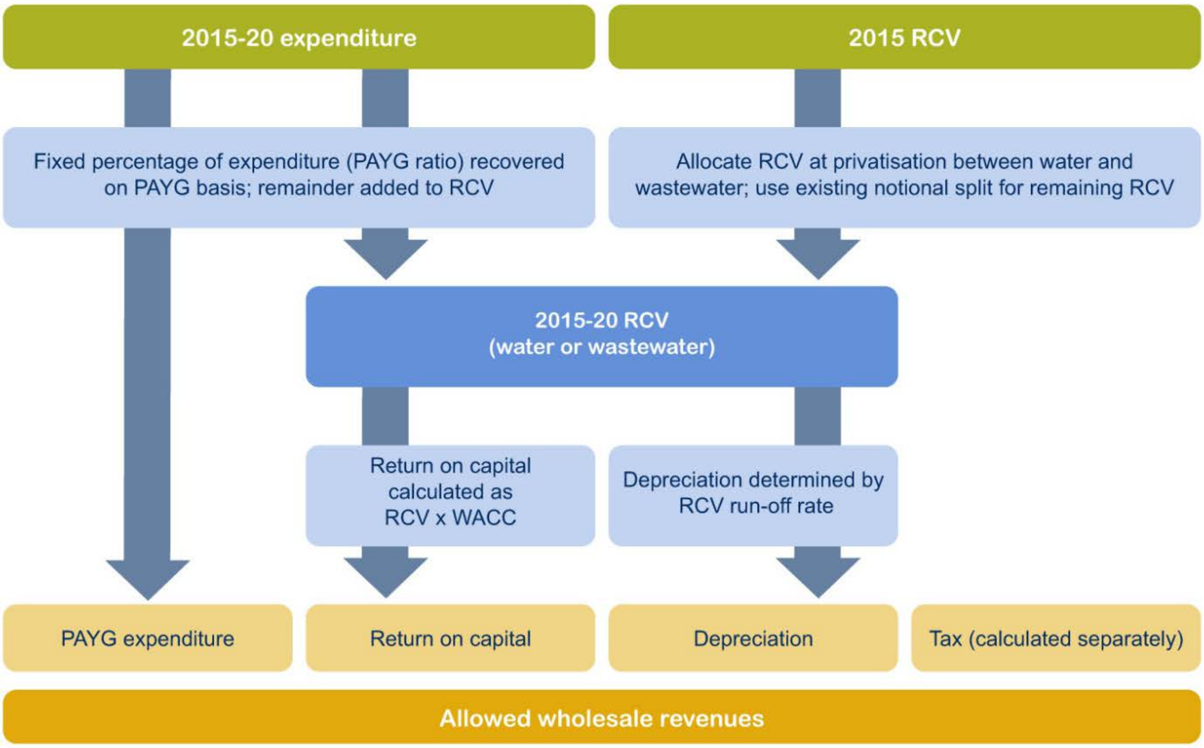
A2.2.1 Structure of wholesale water control

As we set out in our final methodology statement, the overall wholesale water control puts an overall limit on the revenue from charges and cash receipts from connection and infrastructure charges. We also set out that we would retain an RCV approach to the setting of wholesale charges, but that we would make a number of improvements including:

- using a totex approach, where no distinction is made between operating expenditure (opex) and capital expenditure (capex);
- introducing totex menus, which would provide an additional incentive for companies to reveal information and some scope for managing risks and rewards through the cost sharing factor; and
- providing companies with additional flexibility over cost recovery by allowing them to choose what proportion of their expenditure is recovered through the RCV, and through setting the level of depreciation (also known as the RCV run-off).

Figure A1 shows how the wholesale revenues are derived.

Figure A1 Approach to allowed wholesale revenue



The key components of the wholesale charges are as follows.

- Totex baseline for water, which represents our own assessment of the efficient level of capital and operating expenditure for each company in the 2015-20 period.
- The PAYG ratio, which represents the company's proposed allocation between totex which is recovered in the 2015 to 2020 period and that which is added to the RCV.
- The RCV, which is composed of the RCV at the start of the period plus additions from totex that are not recovered in the 2015-20 period minus depreciation.
- The return on the RCV, which reflects the vanilla wholesale weighted average cost of capital (WACC) applied to the RCV during the 2015-20 period.
- There are a number of adjustments reflecting the impact of incentive tools from the 2010-15 period such as the revenue correction mechanism (RCM) and capital expenditure (capex) incentive scheme (CIS).
- The corporation tax charge is calculated using the forecast accounting profits.
- 'Other operating income' and 'other income' are taken into account to reduce the revenue required from household and non-household water customers.

Capital contributions, which form the other component of the control, are cash receipts from connection and infrastructure charges.

Subject to our charging rules (as envisaged under the government's proposals in the UK Government's Water Bill) companies will have some flexibility to adjust charges within the control period to allow them to manage unexpected changes in demand.

A2.2.2 Calculation of wholesale water allowed expenditure

The wholesale water price control baseline represents our view of the efficient level of expenditure. Our approach to setting wholesale cost baselines is set out in the technical appendix. In essence, the starting point for our price control baselines is our benchmarking models, the outputs from which we then adjust where appropriate on the basis of well justified company specific arguments and evidence. We then adjust this expenditure to reflect our own policies for particular cost areas, such as defined pension deficit recovery costs and business rates (where we have set out a specific basis for cost recovery and risk sharing). Our menu baselines exclude defined benefit pension deficit recovery costs,third party costs and 2014-15 market opening costs.

Further detail on our assessment of the company's price control baseline expenditure is set out in annex 2 and in 'Risk-based review initial cost threshold water model: Affinity Water', which we have published on our website. We explain the movements in our assessment since the risk-based review in the technical appendix.

The technical appendix notes that for the risk-based review, the cost thresholds were calculated on the basis of our projections of model explanatory variables for each company. For enhanced companies we have used the forecasts of model explanatory variables set out in their business plans to determine their baselines (while preserving the upper quartile cost efficiency challenge used in the risk-based review) for wholesale water. This is on the basis that, for these two enhanced companies, we have relatively high confidence that these cost driver projections are aligned with the companies' delivery commitments to customers.

To convert the menu baseline to a totex allowance for the purpose of this draft determination we have calculated an implied menu choice, which is the ratio of the company's view of totex and our menu baseline. We set out the menu we have used for the draft determination in the technical appendix. The company's implied menu choice for wholesale water is 96.3. As an enhanced company, Affinity will have the opportunity to finalise its menu choice within the range of 80 to 115 once we have published our draft determinations for all companies in full. This will impact the company's allowed expenditure, sharing factor and additional income and consequently its allowed revenue and bills. The allowed expenditure is based on a weighted average of our view of the baseline (75%) and the company's menu choice (25%).

The calculation of totex allowances is shown in table A3. Separate revenue allowances are made for pension deficit recovery costs, third party costs and 2014-15 market opening costs, which are excluded from the menu baselines. The menu approach also allows an 'additional income' component which companies receive as part of allowed revenues – this is set out in table A9 in section A2.2.9.

Pension deficit repair allowances are calculated in line with the approach that we outlined in 'IN 13/17: Treatment of companies' pension deficit repair costs at the 2014 price review'. This is consistent with the allowance made in the 2009 review, with the remaining deficit repair costs borne by shareholders.

Table A3 Wholesale water allowed expenditure (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	AMP6 total
Menu cost baseline[1]	224.2	209.8	213.6	219.4	208.5	1,075.4
Company's view of menu costs[2]						1,036.1
Implied menu choice						96.3
Allowed expenditure from menu	222.1	207.8	211.7	217.4	206.6	1,065.6
Costs excluded from menu	4.1	4.0	4.0	4.0	4.0	19.9
Total allowed expenditure[3]	226.3	211.8	215.6	221.3	210.5	1,085.5
Less pension deficit repair allowance	0.5	0.5	0.5	0.5	0.5	2.7
Totex for input to PAYG	225.7	211.2	215.1	220.8	210.0	1,082.8

[1] See table A1 in the technical appendix for the derivation of menu baselines.
[2] Based on company plan totex minus costs for items excluded from the menu.
[3] Includes pension deficit repair allowance.

A2.2.3 Calculation of PAYG rates and depreciation

To determine the allowed revenue, the wholesale water totex allowance is allocated between the amount recovered in 2015-20 PAYG (referred to as the pay as you go amount) and the amount added to the regulatory capital value (RCV) to be recovered in future periods. A significant proportion of company expenditure is in long life assets, which benefit current and future customers. The allowed revenue will also include RCV depreciation and the return on the RCV as set out in figure A1 above.

Consistent with our methodology, we have allowed all companies to propose their own PAYG ratios and levels of RCV depreciation. The company has revised its proposed PAYG ratios from its original business plan to reflect the risk and reward guidance we published in January 2014 and its position relative to the allowed wholesale cost baselines but has otherwise left its original RCV depreciation proposals unchanged.

Table A4 shows the company's updated proposed PAYG ratios and associated totex recovery for wholesale water, which we have used as the basis for this draft determination.

Table A4 Affinity's wholesale water PAYG ratios

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex (£ million)	225.7	211.2	215.1	220.8	210.0	1,082.8
PAYG %	76.86%	80.30%	77.61%	74.66%	77.63%	77.41%
Resulting PAYG (£ million)	173.5	169.6	166.9	164.8	163.0	837.8

Table A5 shows the depreciation amounts included within the wholesale water charge. The depreciation rates reflect a run-off rate of 4.0% for the RCV as it stands on 31 March 2015 and a totex average life of 25 years for the totex additions to the RCV over 2015-20.

Table A5 Affinity's wholesale water depreciation (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Depreciation on 2015 RCV	37.9	36.3	34.9	33.5	32.2	174.7
Depreciation on totex additions	1.0	2.9	4.7	6.8	8.9	24.3
Total depreciation	38.9	39.3	39.6	40.3	41.0	199.1

A2.2.4 Return on the RCV

Companies receive a return on the RCV, equal to the vanilla WACC, to compensate them for capital value that has not been recovered prior to and in the PR14 period. The January risk and reward guidance set out a single industry cost of capital for wholesale water services of 3.7%. The company has accepted this guidance and so we have used a cost of capital of 3.7% in this draft determination. This results in a return on capital of around £36 million a year over the 2015-20 period.

The return on capital is calculated by applying the cost of capital to the average RCV for the year. The company has calculated its opening RCV for the start of 2015-20 on 1 April 2015 by taking the closing RCV at the end of 2010-15 and adding its view of midnight adjustments to the RCV to reflect:

- its assessment of its performance over 2010-15; and
- its allocation of the £4 million initial award to the company as a result of it achieving enhanced status, which it has chosen to recover through an addition to its 2015-16 RCV.

We have accepted the company's calculation of its opening RCV for our draft determination (see table A6).

The average RCV, set out in table A7 below for each year, takes into account totex additions to the RCV and RCV depreciation.

Table A6 Affinity wholesale water opening RCV (£ million)

	2015-16
Closing RCV 31 March 2015	934.3
Opening RCV 1 April 2015	946.4

Table A7 Affinity wholesale water return on RCV (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RCV	946.4	959.7	962.1	970.6	986.3
RCV additions (from totex)	52.2	41.6	48.2	56.0	47.0
Less depreciation	38.9	39.3	39.6	40.3	41.0

	2015-16	2016-17	2017-18	2018-19	2019-20
Closing RCV	959.7	962.1	970.6	986.3	992.3
Average RCV (year average)	953.1	960.9	966.4	978.5	989.3
Return on capital	35.2	35.5	35.7	36.2	36.6

A2.2.5 Corporation tax

As set out in our final methodology statement, our approach to calculating tax is similar to the method used for the 2009 price review (PR09), but with a simplified and less data intensive approach.

We have used companies' average capital allowance writing-down rates by service for both the brought forward expenditure pools and for new expenditure. We have used Affinity's estimates of the proportion of base expenditure on underground assets, which is treated as operating expenditure in the statutory accounts.

We have based the tax calculation on projected corporation tax rates, profits and assumed levels of tax relief. We have taken account of debt interest payments by using the higher of: companies' actual proportion of debt financing; and the proportion of debt financing assumed in our notional capital structure.

A2.2.6 Income from other sources

Income from other sources is made up of 'Operating income', 'Other income' and third party income. These are revenues that companies charge but do not form part of the regular water bills that customers pay. For Affinity Water these mainly comprise of rechargeable works such as mains diversions but they can also include income from services such as bulk supplies. These revenues are based on the company's forecasts and are set out in table A9 in section A2.2.9.

A2.2.7 Capital contributions from connection charges and revenue from infrastructure charges

This comprises revenue and capital contributions from connection and infrastructure charges (including requisitions and self-lay). These revenues are based on the company's forecasts, and are set out in table A9 in section A2.2.9.

A2.2.8 Reconciling 2010-15 performance

We confirmed in our final methodology statement that, for a number of incentive tools, we would make appropriate adjustments to allowed revenues for 2015-20, to reflect companies' actual performance, costs and revenues when compared to our PR09 assumptions. Table A8 below summarises the revenue adjustments we are making to the company's 2015-20 wholesale water price control to reflect its performance over 2010-15.

Annex 4 provides more detail on our draft determination in this area. It also sets out any other adjustments we are making, such as those relating to equity injections. We are not making any other adjustments for this company.

Table A8 Adjustments to reflect Affinity's performance in 2010-15

£ million	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Service incentive mechanism (SIM)	0.0	0.0	0.0	0.0	0.0	0.0
Revenue correction mechanism (RCM)	0.5	0.5	0.5	0.5	0.5	2.5
Opex incentive allowance (OIA)	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure incentive scheme (CIS)	-1.8	-1.8	-1.8	-1.8	-1.8	-8.8
Other adjustments	-0.8	-0.8	-0.8	-0.8	-0.8	-4.0
Total	**-2.1**	**-2.1**	**-2.1**	**-2.1**	**-2.1**	**-10.4**

A2.2.9 Calculation of allowed revenue

The calculation of the allowed revenue for Affinity's wholesale water control is shown in table A9. Allowed revenue is principally built up from PAYG totex, the return on RCV, depreciation and an allowance for corporation tax.

Overall we consider that the company's wholesale water revenue allowance should be £254.5 million in 2015-16, decreasing by 3.5% to £245.5 million in 2019-20.

Table A9 Affinity wholesale water allowed revenue

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Totex	225.7	211.2	215.1	220.8	210.0	1,082.8
PAYG ratio	76.86%	80.30%	77.61%	74.66%	77.63%	-
Totex additions to the RCV	52.2	41.6	48.2	56.0	47.0	245.0
RCV (year average)	953.1	960.9	966.4	978.5	989.3	-
Wholesale allowed revenue build up:						
PAYG[1]	174.0	170.2	167.5	165.4	163.5	840.5
Return on capital	35.2	35.5	35.7	36.2	36.6	179.3
Depreciation	38.9	39.3	39.6	40.3	41.0	199.1
Tax[2]	1.5	6.8	1.2	0.0	0.0	9.5
Income from other sources	-2.6	-2.6	-2.6	-2.6	-2.6	-13.0
Reconciling 2010-15 performance	-2.1	-2.1	-2.1	-2.1	-2.1	-10.4
Ex-ante additional menu income	1.1	1.0	1.1	1.1	1.0	5.3
Capital contributions from connection charges and revenue from infrastructure charges	8.4	8.4	8.0	7.8	8.0	40.6
Final allowed revenues	**254.5**	**256.5**	**248.3**	**246.1**	**245.5**	**1,251.0**

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.

A2.3 Uncertainty mechanisms

In our risk and reward guidance, we acknowledged that all companies face uncertainty about future costs and revenues. We consider that appropriate risk sharing mechanisms provide companies with incentives to reduce costs and provide better services.

Companies already have access to a range of uncertainty mechanisms which share risks between companies and customers. In our final methodology statement, we noted that additional risk should only be fully transferred to customers when companies are unable to influence the impact on their business. As set out in our risk and reward guidance, when a company is able to materially influence the probability or magnitude of impacts, or mitigate the effect efficiently, then the risk should remain with the company, at least in part. This provides companies with strong incentives to manage risks.

In our risk and reward guidance the one area where we did consider an uncertainty mechanism was appropriate was for the revaluation of wholesale water business rates in 2017, although we considered that companies should retain a residual incentive, in order to argue for reasonable treatment in the rating review on behalf of customers.

The company has accepted this risk and reward guidance on uncertainty mechanisms.

The company withdrew its earlier proposals for a change mechanism which could cover statutory obligations (from the Water Framework Directive), the adoption of customer supply pipes, costs related to the Open Water programme and obligations from major infrastructure developments such as HS2.

Therefore, in this draft determination, we have not provided for other uncertainty mechanisms, beyond those set out in the company's licence in line with the January risk and reward guidance.

In line with our risk and reward guidance, and based on the company's March business plan, water business rates should be a notified item for PR14 and as such could qualify for an interim determination, which allows price controls to be adjusted between period reviews. The formal interim determination mechanism is set out in each company's licence. It can only be triggered by relevant items, the value of which, in aggregate, must exceed 10% of a company's turnover. As proposed by Affinity, the uncertainty mechanism would pass through 75% of changes in water business rate costs to customers, with the company retaining 25% of the cost risk.

We consider that this should provide a sufficient incentive on the company to minimise costs.

Relevant items are classified as either notified items or relevant changes of circumstances (RCCs).

A2.4 Return on regulated equity

As set out in our final methodology statement, we are taking a systematic and quantitative approach to analysing how companies are managing their risks and its allocation between companies' investors and customers. We proposed to use an approach based on scenario modelling to analyse risk and explore the overall balance of risks to return on regulated equity (RoRE).

Consistent with our risk and reward guidance, as part of its revised business plan submission, Affinity conducted detailed scenario analyses to assess the potential RoRE range at the company level. Based on this, as part of our risk-based review of the company's business plan, we have calculated the overall RoRE range for wholesale water, shown in figure A2 below, split into the constituent risk components, such as totex and outcome delivery incentive under and outperformance. The risk range is expressed on a P10/P90 basis such that there is a 10% probability of an outturn occurring below the charted range and an equal likelihood of achieving a return above the charted range.

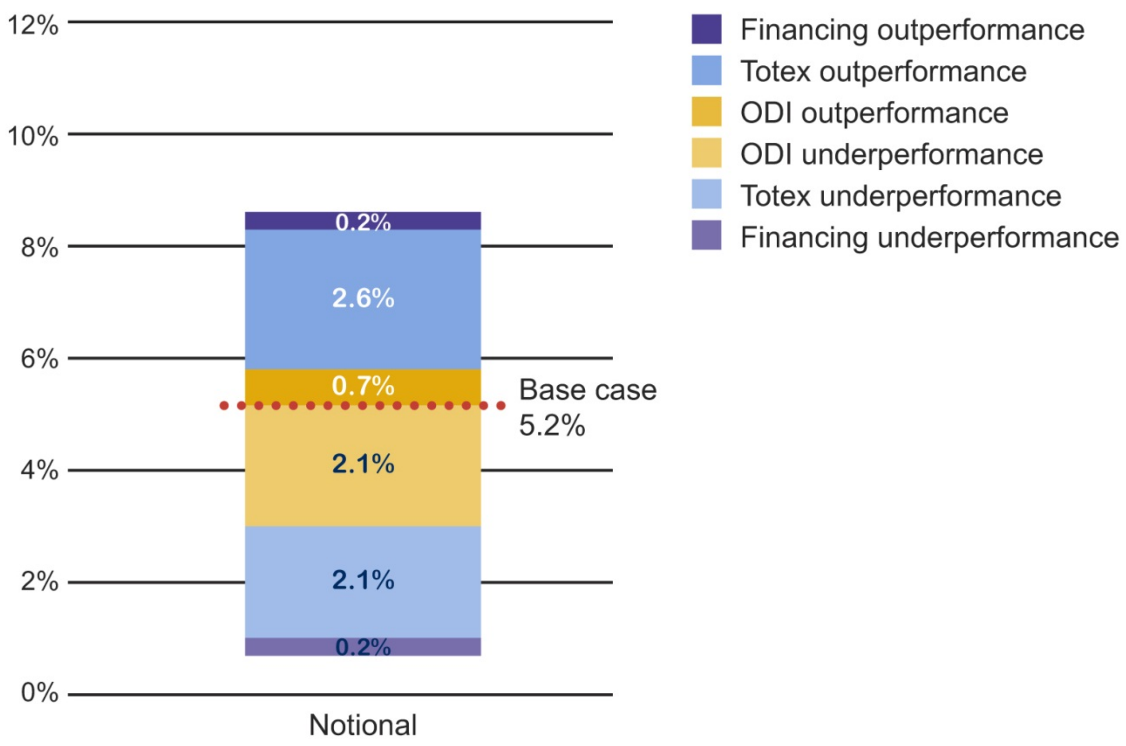
For wholesale water the RoRE range is 0.7% to 8.6%, with a base case of 5.2%. Risk ranges for individual elements (cost, ODIs, and finance) are generally consistent with our risk and reward guidance.

- We have calculated that Affinity Water's business plan would result in an ODI range of -2.1% to +0.7%. The reward is outside the range of ±1% to ±2% we suggested in our guidance on risk and reward. We consider that the magnitude of the reward for individual ODIs is consistent with our guidance on outcomes. Viewing the package as a whole, we consider that the magnitude of Affinity ODI reward is acceptable: it is sufficiently large to create appropriate incentives for outperformance, but given AFW's current relative performance does not expose customers to unacceptable bill risk.

- We have calculated that Affinity Water's March business plan would result in a cost risk range of -2.1% to +2.6%. We consider that this range is based on a plausible high and low case for the overall scenario, and that the cost impacts are sufficiently evidenced. Affinity Water has provided us with a complete set of assumptions made to derive the totex impacts in Scenario I, including its assumptions about inflation, and we are satisfied that these assumptions are plausible.

- We also consider that the magnitude of this range is broadly consistent with historical evidence, as presented in figure 12 of our guidance on risk and reward.

Figure A2 Affinity Water RoRE range – wholesale water



Source:
Ofwat's risk-based review analysis based on company business plan table A20. Analysis does not reflect changes or assumptions made since the completion of the risk-based review.

A3. Household retail

A3.1 Company outcomes, performance commitments and delivery incentives

The outcome performance commitments and delivery incentives we are adopting for the company's household retail control are summarised in table A10 below. These reflect the company's own business plan proposals after consultation with its customers and customer challenge group. They include the revisions it made in response to our risk and reward guidance and following the general principles and process set out in the technical appendix. Annex 1 sets out the detail of the outcomes, performance commitments and incentives that we are consulting on as part of our draft determination.

The outcomes we are adopting include the service incentive mechanism (SIM) that applies to all companies.

Any SIM incentive reward or penalty due will be determined by comparing company's household SIM performance over four years (2015-16 to 2018-19) to the industry performance. The reward or penalty will range between +6% and -12% of 2019-20 household retail revenues; and we will adjust retail household revenues from 2020-21. The weights attached to the SIM performance measures will comprise 75% from qualitative survey results and 25% from quantitative measures as set out in 'Service incentive mechanism (SIM) for 2015 onwards – conclusions'. The details of these are currently being tested by companies and we will confirm the final methodology before April 2015.

Table A10 Household retail outcomes, performance commitments and incentives

Outcome	Performance commitment	Incentive type
Providing a value for money service	Service incentive mechanism (SIM)	Financial – reward and penalty
	Value for money survey	Reputational

A3.2 Costs

In our final methodology statement, we confirmed that our household retail price controls would be based on setting a revenue control for each company based on the efficient costs of retail activities (as measured by the average cost to serve, or ACTS) based on customer numbers. Setting household price controls for 2015-20 on the basis of 'average' costs of companies is part of an evolutionary approach that we hope will enable us to move to an efficient cost to serve over future price controls. As part of this process, we confirmed that we would adjust the ACTS to account for levels of metering. We also confirmed that companies could seek additional adjustments to the ACTS if certain criteria were met, as discussed further below.

A3.2.1 Adjustments

Our final methodology statement confirmed that companies could seek additional adjustments to their ACTS where they were able to demonstrate with sufficient and convincing evidence that:

- those costs were material to their company;
- that they were driven by factors beyond efficient management control; and
- that they impacted the company in a materially different way to other companies.

Each of these criteria is of equal importance. The first criterion ensures that adjustments to the ACTS are only made for material items. The second criterion ensures that companies needed to provide sufficient and convincing evidence that the particular factor was beyond management control and that there was a clearly evidenced causal relationship between that factor and the costs of providing retail services to household customers in their area. Similarly, companies needed to demonstrate under this criterion that their management practises in this area were efficient, or to reflect their level of inefficiency suitably in their adjustment request. The third criterion ensures that adjustments to the ACTS are only made for items that impact companies in a materially different way to other companies, given that the ACTS will account for any items that impact companies in the same way.

Affinity did not include any adjustments to its cost to serve in its business plan.

Table A11 Household retail adjustments (£ million)

	Units	2015-16	2016-17	2017-18	2018-19	2019-20	Total
n/a	£ million	0.00	0.00	0.00	0.00	0.00	0.00

Note: there will be no indexation for retail price controls from this price base.

A3.2.2 New costs

As set out in the technical appendix, our methodology allows for the possibility of a modification to a company's cost to serve for new costs. Affinity included new costs for schemes that could result in a modification being made in its business plan. However, the company has forecast a falling cost profile. Overall the new costs are offset by the falling cost profile so no modification for new costs has been made.

Table A12 New household retail costs (£/customer)

	Units	Value
Modification made to 2013-14 CTS for ACTS calculation	£/customer	0.00

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

A3.3 Calculating the allowed revenues

We set out our approach to calculating the average cost to serve in the technical appendix. Using the average industry allowances per customer and the projected customer numbers in the company's business plan (see annex 3), we have calculated the total allowed household retail revenues in 2012-13 prices, including the efficiency challenge and the household retail net margin.

A3.3.1 Net margins

In our risk and reward guidance we confirmed that our view of an appropriate net margin was 1% for household retail price controls. Table A13 below shows the household retail net margin over 2015-20.

The retail net margin applies to total household costs and is therefore applied to wholesale charges to supply households, plus allowed household retail costs.

Table A13 Household retail net margins

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

Table A14 below sets out the components of the allowed household retail revenue.

Table A14 Components of the allowed household retail revenue

	Units	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Company cost to serve unmetered single service customers	£/customer	£16.05					
Company cost to serve metered water-only customers	£/customer	£24.92					
Allowed cost to serve unmetered single service customers[1]	£/customer		£14.57	£14.15	£13.68	£13.18	£12.79
Allowed cost to serve metered water-only customers	£/customer		£22.79	£21.70	£20.57	£19.42	£19.02
Total allowed cost to serve (excluding net margin)	£ million		25.6	25.3	24.8	24.1	24.1
Total household wholesale charge (including forecast RPI)	£ million		215.0	224.1	224.7	230.1	236.5
Total household retail revenue (including net margin)	£ million		28.1	27.8	27.3	26.7	26.7

[1] Allowed cost to serve includes pension deficit repair costs.

Note:

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

As we set out in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', we will make a modification to allowed revenues to account for the difference between actual and forecast customer numbers. The details of how this difference is calculated and the modification factors for calculating the value of this modification are set out in annex 3.

A3.4 Uncertainty mechanisms

In our risk and reward guidance, we acknowledged that all companies face uncertainty about future costs and revenues. We consider that good risk sharing mechanisms provide companies with incentives to reduce costs and provide better services.

Companies already have access to a range of uncertainty mechanisms which share risks between companies and customers. In our final methodology statement, we noted that additional risk should only be fully transferred to customers when companies are unable to influence the impact on their business. As set out in our risk and reward guidance, when a company is able to materially influence the probability or magnitude of impacts, or mitigate the effect efficiently, then the risk should remain with the company, at least in part. This provides companies with strong incentives to manage risks.

The company did not propose any specific uncertainty mechanisms for household retail and has accepted the risk and reward guidance on uncertainty mechanisms.

A3.5 RoRE

Consistent with the approach set out in our risk and reward guidance and based on Affinity Water's revised business plan submission, we have calculated a retail net margin range of -0.9% to +1.3% around the central estimate of 1%.This range is the result of retail cost risk and a SIM downside worth 1.2% of invoiced revenue. This analysis is based on Affinity Water's submission of March 2014 and does not reflect the updated retail cost allocation. We are content that retail is self-financing following the update to Affinity's cost allocation.

Affinity did not submit any financial ODIs for its retail business (apart from SIM). Given that the national SIM and GSS service quality mechanisms incentivise performance in household retail services, we consider that this is acceptable.

We have calculated that Affinity's business plan would result in a potential underspend of 0.7% of retail revenue, and a possible overspend of 0.3%. We consider that this range is based on a plausible high and low case for the overall scenario, and that the cost impacts are sufficiently evidenced. Affinity provided us with a complete set of assumptions made to derive the totex impacts in Scenario I and we are satisfied that these assumptions are plausible. We also consider that the magnitude of this range is broadly consistent with historical evidence.

On SIM, we calculated that Affinity's business plan assumptions would result in a downside of 1.2% of revenue, but no upside.[2] While the proposed SIM RoRE impact exceeds the range suggested in our guidance on risk and reward, Affinity have explained that this is based on the challenges associated with the impact of Thames Tideway on wastewater bills and the roll out of metering. We consider that Affinity's forecast impacts are plausible. SIM impacts are consistent with a range of SIM rewards/penalties of -1% to +0.5% of total revenue, and reflect Affinity's greater revenue relative to RCV.

[2] This submission is inconsistent with our current guidance on SIM, which was published on 4 April 2014, after Affinity submitted its revised business plan. But we consider that Affinity made reasonable assumptions about its likely future SIM scores. Specifically, it assumed that there was some likelihood that it would fall behind the industry average by one standard deviation or more, but that it was unlikely that it would outperform the industry average by more than one standard deviation.

A4. Non-household retail

A4.1 Default tariffs

As described in the technical appendix, we have included financial assumptions for an indicative price control for non-household retail to support our appointee-level financeability assessment. This is based on the total non-household retail costs as presented in the company's own business plan table A19, and the net margin of 2.5% relevant for the company as set out in our risk and reward guidance.

The retail net margin applies to total non-household costs and is therefore applied to wholesale charges to supply non-households, plus allowed non-household retail costs.

The table below gives the indicative revenues from default tariffs that we have included in this draft determination for financeability assessment purposes. The table assumes an aggregate flat net margin profile for the overall non-household retail business. Note that companies are free to propose different net margin profiles for specific default tariffs within the overall business if they consider this to be appropriate, but the non-household margins in aggregate should not be greater than the amounts proposed in our risk and reward guidance, as discussed in 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs'.

Table A15 indicative non-household retail total revenue price control including net margins

	Units	2015-16	2016-17	2017-18	2018-19	2019-20
Indicative non-household retail total revenue price control including net margins	£ million	4.7	4.7	4.7	4.6	4.6

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

A5. Appointee financeability

As we set out in our final methodology statement, one of our statutory duties is to ensure that an efficient company is able to finance its functions, in particular by securing reasonable returns on its capital.

Consistent with our methodology, we consider that the onus is on companies to demonstrate that they are financeable. As set out in the our final methodology statement, our preferred approach is that companies assure themselves of their financeability through:

- an assessment of financeability (and financial ratios) at a whole company level – using aggregated revenues, costs and cash flows associated with regulated activities across all the price controls we set;
- an assessment of financeability on the basis of the appointee having a notional capital structure and associated costs of finance as prescribed in our risk and reward guidance published in January 2014;
- companies demonstrating that projected financial ratios are at levels which allow them efficiently to finance their functions; and
- assess whether the activities covered by the retail price controls are financeable in their own right.

As set out in our final methodology statement, we have asked companies to demonstrate their financeability by providing financial ratios in their business plans. The financial ratios are those typically reviewed by credit rating agencies for testing credit risk and the risk of default on debt. Further ratios, which are more relevant to equity investors are also considered.

The recommendation (enhancement) document on Affinity Water that we published on 4 April 2014 explained that we had sufficient and convincing evidence from the company that its updated business plan was financeable.

It also explained that we tested the company's updated business plan submission using our own financial model. This assessment revealed some differences between the financial ratios submitted by Affinity Water and the ratios we calculated using Affinity's inputs in our own financial model (the results are set out in table A16 below) at that time.

The recommendation (enhancement) document explained the differences between the Affinity model calculations and the Ofwat model and noted that the differences suggest that Affinity is in fact more comfortably financeable than indicated by their submission.

Table A16 Company and Ofwat financial ratio calculations

Financial ratios for notional company	Affinity calculation (average 2015-20)	Ofwat calculation (average 2015-20)
Cash interest cover	3.52	3.70
Adjusted cash interest cover ratio (ACICR)	2.11	2.29
Funds from operations/debt	11.70%	12.80%
Retained cashflow/debt	7.31%	10.26%
Gearing	62.50%	62.5%
Dividend cover (profit after tax/dividends paid)	1.41	2.63
Regulatory equity/regulated earnings for the regulated company	38.73	41.06
RCV/EBITDA	8.96	8.66

We note that the cash interest cover, adjusted cash interest cover and funds from operation/debt are broadly consistent with ratios used by the Competition Commission in their final determination for Northern Ireland Electricity (NIE)[3]. Affinity's proposed ratios are above the target ratios set out by the Competition Commission (CC).

For the draft determination, the implied menu choice for wholesale water is below our own baseline (see section 2.2.2). As a result, the draft determination assumes total expenditure is marginally higher than that assumed in the company's business plan. In addition the draft determination reflects our notional assumption about dividend distribution (that is, yield of 4.0% and real growth in dividends of 1.65%)

The updated results with these new assumptions are set out in table A17 below.

[3] https://assets.digital.cabinet-office.gov.uk/media/534cd495ed915d630e00003f/final-determination.pdf

Annex 1: Outcomes, performance commitments and outcome delivery incentives

This annex sets out in detail the performance commitments and outcome delivery incentives we are proposing for the company's wholesale water and household retail outcomes. The performance commitments and outcome delivery incentives reflect the company's own business plan proposals, including the revisions it made in response to our January risk and reward guidance, following the general principles and process set out in the technical appendix.

The annex is organised with the wholesale outcomes and associated performance commitments and delivery incentives presented first, followed by the household retail outcomes. The annex provides the following information on each performance commitment:

- the name and detailed definition of the performance commitment;
- the type of incentive;
- the performance commitment level;
- the limits on rewards and penalties (caps and collars) and neutral zones (deadbands) as applicable;
- the incentive rates, if applicable; and
- additional details on the measure.

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

The company has calibrated its ODIs to take account of the interaction with totex efficiency sharing as it is required to do by the price review methodology. In its business plan and subsequent revisions the company has used a 50% cost sharing rate. This was the example cost sharing rate we used in appendix 1 to our final methodology statement. On 4 April we stated that the company had achieved enhanced status and that its cost sharing rate at 100 would be 55% rather than 50%. We have not asked the company to recalibrate its ODIs using a cost sharing rate of 55%. Once the company has chosen its position on the enhanced menu it will then need to recalibrate its ODIs with the cost sharing rate associated with that position.

We currently anticipate that Affinity – as an enhanced company – will be able to finalise its proposed menu choice and ODI calibrations in the light of our full draft determinations for all companies, so that these can be reflected in the final determination published on 12 December.

Outcome: making sure our customers have enough water, whilst leaving more water in the environment

Performance commitment: leakage

Detailed definition of performance measure

Leakage is measured on an average Ml/d a year basis. We have used the Ofwat item reference BN2345.

Incentive type

Financial reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Ml/d	189.3	183.9	178.5	173.1	167.7	162.2
Penalty collar	Ml/d	n/a	211.9	206.5	201.1	195.7	190.3
Penalty dead band	Ml/d	n/a	n/a	n/a	n/a	n/a	n/a
Reward dead band	Ml/d	n/a	170.2	170.2	170.2	167.7	162.2
Reward cap	Ml/d	n/a	155.9	150.5	145.1	139.7	134.3

Incentive rates

Incentive type	Performance levels (Ml/d)		Incentive rate (£/Ml/d/year)
	Lower	Upper	
Penalty	162.3	211.9	0.241 million
Reward 1	170.1	162.2	0.075 million
Reward 2	162.1	134.3	0.112 million

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	l/p/d	158.4	156.3	155.6	153.3	150.3	147.4
Penalty collar	l/p/d	n/a	n/a	n/a	n/a	n/a	n/a
Penalty dead band	l/p/d	n/a	n/a	n/a	n/a	n/a	n/a

Incentive rates

Incentive type	Performance levels (l/p/d)		Incentive rate (£/year)
	Lower	Upper	
Penalty 1	153.4	153.4	0.750 million
Penalty 2	147.5	147.5	1.750 million

Additional details

Necessary detail on measurement units	The unit of measurement is post-MLE weighted average litres per person per day on average over the year
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually
Timing and frequency of rewards/penalties	Penalties will be applied based upon a pass/fail assessment in year 3 (2017-18) and year 5 (2019-20) against our performance commitment for that year.
Form of reward/penalty	Adjustment to revenue
Any other information or clarifications relevant to correct application of incentive	No other information required

Performance commitment: water available for use

Detailed definition of performance measure

Water available for use (WAFU) is made up of deployable output (the amount that works can produce and include any imports/exports) minus an amount for climate change, sustainability reductions and outages (planned and unplanned site failures). The units for WAFU are Ml/d average over the year.

The company will use its dry year annual average (DYAA) baseline forecast to monitor its performance in achieving its outcome as this is the scenario that influences capacity investment and corresponds to environmental benefits and these will be most obvious in a dry year condition. The company will measure changes in its baseline each year compared to the end year of AMP5.

Incentive type

Financial penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Ml/d	1114.7	1110.4	1103.5	1100.8	1068.1	1067.0
Penalty collar	Ml/d	n/a	n/a	n/a	n/a	n/a	n/a
Penalty dead band	Ml/d	n/a	n/a	n/a	n/a	n/a	n/a

Incentive rates

Incentive type	Performance levels (Ml/d)		Incentive rate (£/year)
	Lower	Upper	
Penalty 1	1100.7	1100.7	0.590 million
Penalty 2	1066.9	1066.9	1.910 million

Additional details

Necessary detail on measurement units	The units for WAFU are Ml/d average over the year. Performance will be measured based on change from our DYAA baseline for end of AMP5.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Penalties will be applied based upon a pass/fail assessment in year 3 (2017-18) and year 5 (2019-20) against the performance commitment for that year.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Performance commitment: sustainable abstraction reductions

Detailed definition of performance measure

This performance measure is the cumulative reduction of the company's average deployable output required by the end of the year. This is line with the company's water resources management plan.

Incentive type

Financial reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Ml/d	0.0	-6.7	-12.5	-14.1	-42.1	-42.1
Penalty collar	Ml/d	n/a	0.0	0.0	0.0	0.0	0.0
Penalty dead band	Ml/d	n/a	n/a	n/a	n/a	n/a	n/a
Reward dead band	Ml/d	n/a	n/a	n/a	n/a	n/a	n/a
Reward cap	Ml/d	n/a	-6.7	-15.5	-35.7	-42.1	-42.1

Incentive rates

Incentive rate	Performance levels (Ml/d)		Incentive rate (£/Ml/d/year)
	Lower	Upper	
Penalty	-42.0	0.0	0.068 million
Reward	-6.8	-35.7	0.068 million

Additional details

Necessary detail on measurement units	Measurement units are Ml/d based upon the cumulative reduction of the company's average annual deployable output over AMP6.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Rewards and penalties will apply annually.
Form of reward/penalty	Adjustment to revenue.

Any other information or clarifications relevant to correct application of incentive	This ODI is related to the pace of delivery, rather than over- or under-performance of a service level. There is a single incentive rate of £0.068 million per Ml, which will apply as either a penalty or a reward depending on whether the company has over- or under-delivered against its performance commitment in any given year.

Outcome: supplying high quality water you can trust

Performance commitment: compliance with water quality standards

Detailed definition of performance measure

The performance measure is mean zonal compliance. Mean zonal compliance is the average of the compliance rates (at zone level) for 39 parameters that are tested to establish the quality of water and is the main measure used by Drinking Water Inspectorate to demonstrate compliance.

Incentive type

Financial penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	%	99.95	99.95	99.95	99.95	99.95	99.95
Penalty collar	%	n/a	n/a	n/a	n/a	n/a	n/a
Penalty dead band	%	n/a	n/a	n/a	n/a	n/a	n/a

Incentive rates

Incentive rate	Performance levels (%)		Incentive rate (£/year)
	Lower	Upper	
Penalty	n/a	99.94	0.720 million

Additional details

Necessary detail on measurement units	The unit is percentage compliance with standards a year on a calendar year basis.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	This will be a pass/fail annual assessment against the performance commitment.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Performance commitment: customer contacts for discolouration

Detailed definition of performance measure

This is a measure of customer contact for discolouration calculated as the weighted average (as per the current AMP5 reference level). The unit is the number of contacts per 1,000 of population – an index score a year (calendar year).

Incentive type

Financial penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Nr/1000 /popn.	0.66	0.66	0.66	0.66	0.66	0.66
Penalty collar	Nr/1000 /popn.	n/a	1.30	1.30	1.30	1.30	1.30
Penalty dead band	Nr/1000 /popn.	n/a	n/a	n/a	n/a	n/a	n/a

Incentive rates

Incentive rate	Performance levels (nr/1000/popn.)		Incentive rate (£/nr/1000/popn./year)
	Lower	Upper	
Penalty	0.67	1.30	0.438 million

Additional details

Necessary detail on measurement units	The unit is the number of contacts per 1,000 of population served – an index score a year (calendar year).
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Penalties will be assessed annually.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Outcome: minimising disruption to you and your community

Performance commitment: unplanned interruptions to supply over 12 hours

Detailed definition of performance measure

This is the number of properties affected by an unplanned interruption to supply of over 12 hours. The definition we have used here is that given in Ofwat item reference BN1008, as used for the DG3 infrastructure serviceability measure through the AMP5 period.

Incentive type

Financial reward and penalty.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Nr props.	320	320	320	320	320	320
Penalty collar	Nr props.	n/a	775	775	775	775	775
Penalty dead band	Nr props.	n/a	505	505	505	505	505
Reward dead band	Nr props.	n/a	135	135	135	135	135
Reward cap	Nr props.	n/a	0	0	0	0	0

Incentive rates

Incentive rate	Performance levels (nr props.)		Incentive rate (£/property/year)
	Lower	Upper	
Penalty	506	775	5,410
Reward	134	0	975

Additional details

Necessary detail on measurement units	Measurement units are number of properties affected a year basis. The exact definition we have used here is that given in Ofwat item reference BN1008.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Rewards and penalties will apply annually.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Performance commitment: number of burst mains

Detailed definition of performance measure

This is measured on number of mains bursts a year – Ofwat item reference BN1225. The number of mains bursts (excludes ferrule bursts FE2 and FE3) to enable consistent measurement on a unified single company basis.

Incentive type

Financial penalty only.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Nr	3,100	3,100	3,100	3,100	3,100	3,100
Penalty collar	Nr	n/a	4,350	4,350	4,350	4,350	4,350
Penalty dead band	Nr	n/a	3,500	3,500	3,500	3,500	3,500

Incentive rates

Incentive rate	Performance levels (nr)		Incentive rate (£/nr/year)
	Lower	Upper	
Penalty	3,500	4,350	2,665

Additional details

Necessary detail on measurement units	The unit of measurement is number of mains bursts a year – Ofwat item reference BN1225.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Penalties will apply annually.
Form of reward/penalty	Adjustment to revenue.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Performance commitment: affected customers not notified of planned interruptions

Detailed definition of performance measure

This is a Guaranteed Standards of Service (GSS) measure – Ofwat item reference GSS00010. The definition is the number of customers not notified of a planned interruption to supply of over 4 hours' duration. The definition for 'customer' is that given in the Water Supply and Sewerage Services (Customers Service Standards) Regulations 2008.

Incentive type

Non-financial.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Nr. GSS events	110	110	110	110	110	110

Incentive rates

While there is no financial outcome delivery incentive, every property, both domestic and non-domestic, that is affected will receive an enhanced GSS compensation payment of £50. Entitlement to payment will be assessed in accordance with the regulations and subject to the same limitations and exclusions.

Additional details

Necessary detail on measurement units	The measurement units are the number of GSS events – as defined by Ofwat item reference GSS00010.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Not applicable.

Form of reward/penalty	Not applicable.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Performance commitment: planned work taking longer to complete than notified

Detailed definition of performance measure

This is a Guaranteed Standards of Service (GSS) measure and is based on the overruns of planned and warned interruptions to supply - Ofwat item reference GSS00012.

Incentive type

Non-financial.

Performance commitments

		Starting level	Committed performance levels				
	Unit	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Performance commitments	Nr. GSS events	550	550	550	550	550	550

Incentive rates

While there is no financial outcome delivery incentive, every property, both domestic and non-domestic, that is affected will receive an enhanced GSS compensation payment of £50. Entitlement to payment will be assessed in accordance with the regulations and subject to the same limitations and exclusions.

Additional details

Necessary detail on measurement units	The measurement units are the number of GSS events – as defined by Ofwat item reference GSS00012.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Not applicable.
Form of reward/penalty	Not applicable.
Any other information or clarifications relevant to correct application of incentive	No other information required.

Outcome: providing a value for money service

Performance commitment: value for money survey

Detailed definition of performance measure

A quantitative value for money customer survey to support the specific assessment of the company's value for money measure. The survey will be complementary to the assessment of customer service delivered through SIM.

The survey will be developed in detail over the next few months with the input of the Consumer Council for Water (CCWater), community groups and other relevant customer representative bodies such as the Citizens' Advice Bureau. The company will move to trial phase during summer 2014. The first survey will establish the company's baseline performance commitment against which it will measure its performance during AMP6.

Incentive type

Non-financial.

Performance commitments

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

Incentive rates

This is a non-financial outcome delivery incentive.

Additional details

Necessary detail on measurement units	To be confirmed following engagement with key stakeholders.
Frequency of PC measurement and any use of averaging	Performance will be measured against the performance commitment annually.
Timing and frequency of rewards/penalties	Not applicable.
Form of reward/penalty	Not applicable.
Any other information or clarifications relevant to correct application of incentive	

Annex 2: Wholesale costs

We have developed cost models that explain the patterns of historical costs across companies, and, combined these with forecasts/projections of the model explanatory variables and efficiency assumptions, to derive basic cost thresholds (BCTs) for each company. Further details can be found in the BCT model overview, the technical appendix and the BCT feeder models published alongside this draft determination.

We have then made three categories of adjustments to these basic cost thresholds.

- **Policy additions** – which reflect areas of costs excluded from the base modelling across all companies or adjustments necessary to ensure comparisons with business plan forecasts of totex are made on a like for like basis (such as the third party cost and gross/net adjustments).
- **Unmodelled allowances** – to cover areas of enhancement spending not covered by the enhancement modelling (but implicitly included in two out of the three approaches to water cost modelling that are based on a totex approach – hence the final adjustment to the water cost threshold is 1/3 of the total).
- **Deep dive adjustments** – to capture those special aspects of business plans not provided for in the base cost thresholds, policy additions and unmodelled allowances. These are explained in more detail in the cost templates published alongside this document.

Taken together these adjustments translate the basic cost thresholds to draft determination thresholds.

Where companies made arguments in business plans for special aspects of their plans and we assessed these in detail but decided that it was not appropriate to adjust the cost thresholds then these have been categorised as ‘deep dives not added’.

All of the above are summarised in the tables below – together with business plan forecast totex and the difference between the forecast and the draft determination threshold.

Table A18 Movement from basic cost threshold to draft determination threshold for wholesale water totex

Basic cost threshold £ million	Policy additions £ million	Unmodelled costs adjustment £ million	Deep dive £ million	Draft determination threshold £ million[1]	Deep dives not added	Deep dives not added	Deep dives not added	Deep dives not added
1,015	90	-10	1 (overlap scheme)	**1,095**	Karstic water (£1 million) – not added as not material	Universal metering (£53 million) – already reflected in models	Reservoirs (£18 million) – already reflected in models	River Thames WTW (£13 million) – already reflected in models

Table A19 Policy additions to the basic cost threshold

Business rates £ million	Pension deficit payments £ million	Third party costs £ million	Open market costs £ million	Net v gross adjustments £ million	Total £ million
69	3	17	1	0	**90**

Table A20 comparison of company wholesale water totex with the draft determination threshold and 2010-15 totex

Plan £ million	Draft determination threshold £ million	Gap £ million	Plan versus 2010-15
1,049	1,095	-47 (-4%)	+3%

Annex 3: Household retail price control

Revenue modification

Total allowed revenues are set based on the number of customers and meter penetration set out in companies' business plans. If actual customer numbers or meter penetration differ from forecast values, then a modification will be made to allowed revenues to account for this.

Table A21 below sets out the amount per customer that allowed revenues will be modified by if outturn customer numbers differ from forecast customer numbers. This is set for each of the customer types.

These modification factors include an allowance for the net margin. This allowance is set based on forecast nominal wholesale charges. These modification factors will not be updated for differences between forecast and actual nominal wholesale charges. This is because doing so would make the calculation of these modification factors each year considerably more complex and less transparent. We consider that setting these modification factors out in advance and not varying them for changes in wholesale is a more proportionate and appropriate approach.

For example, consider the case where the number of un-measured water only customers is lower than forecast and the number of measured water only customers is higher than forecast due to an unanticipated more rapid meter roll out. We would make a downward adjustment for revenue for un-measured water only customers, and a more than offsetting upward adjustment for measured water only customers.

The first table below sets out what these modification factors are and the second sets out the baseline number of customers.

Table A21 Household retail allowed revenue modification factors by class of customer

	Units	2015-16	2016-17	2017-18	2018-19	2019-20
Revenue modification per un-measured water only customer	(£/ customer)	£15.96	£15.56	£15.07	£14.59	£14.18
Revenue modification per measured water only customer	(£/ customer.)	£24.95	£23.87	£22.66	£21.48	£21.10

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

Table A22 Assumed number of customers for household retail total revenues

	Units	2015-16	2016-17	2017-18	2018-19	2019-20
Number of un-measured water only customers	'000s	655.525	590.377	517.641	446.497	387.719
Number of measured water only customers	'000s	705.162	778.878	859.986	939.218	1006.121

Annex 4: Reconciling 2010-15 performance

Wholesale adjustments

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

In our risk-based review, we considered the company's proposals for adjustments to reconcile 2010-15 performance using a test based on two assessments. The first examined to what extent it had demonstrated clear evidence that it had made adjustments to 2015-20 price controls based upon its performance in 2010-15 in line with our guidance and tools. The second examined how fairly the company's proposals reflected its performance in 2010-15 including the scale of difference between its view and the Ofwat view for each of the five tools. For enhanced companies, where the company's view was within 5% of Ofwat's view (or was in customers' favour) we have accepted the company position for the purposes of this draft determination.

In appendix 2 of 'Setting price controls for 2015-20 – pre qualification decisions', we confirmed our risk-based review scores for the company's adjustments submitted in its business plan.

On 10 March Affinity Water pre-qualified as an enhanced company, and it had a limited number of actions to address - one of these actions was to ensure compliance with Ofwat rules and guidance on legacy adjustments and to make sure that the proposed adjustments accurately reflect performance between 2010 and 2015. Affinity provided additional evidence and on 4 April we confirmed that it had complied with this action. This draft determination uses the updated evidence on legacy adjustments provided by the company.

Table A23 below compares the company's view of the required revenue adjustments included in its final business plan for each of the incentive tools, with our own view. The table also shows other adjustments such as those relating to tax. For the purposes of setting this draft determination we have used the company's proposed adjustments.

Table A23 Revenue adjustments in the water service 2015-20

£ million		2015-16	2016-17	2017-18	2018-19	2019-20	Total
Service incentive mechanism (SIM)	Company view	0.0	0.0	0.0	0.0	0.0	0.0
	Ofwat view	0.0	0.0	0.0	0.0	0.0	0.0
Revenue correction mechanism (RCM)	Company view	0.5	0.5	0.5	0.5	0.5	2.5
	Ofwat view	0.5	0.5	0.5	0.5	0.5	2.5
Opex incentive allowance – post tax (OIA)	Company view	0.0	0.0	0.0	0.0	0.0	0.0
	Ofwat view	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure incentive scheme (CIS)	Company view	-1.8	-1.8	-1.8	-1.8	-1.8	-8.8
	Ofwat view	-1.8	-1.8	-1.8	-1.8	-1.8	-8.8
Tax refinancing benefit clawback	Company view	-0.8	-0.8	-0.8	-0.8	-0.8	-4.0
	Ofwat view	-0.8	-0.8	-0.8	-0.8	-0.8	-4.0
Other tax adjustments	Company view						0.0
	Ofwat view						0.0
Equity injection clawback	Company view						0.0
	Ofwat view						0.0
Other adjustments	Company view						0.0
	Ofwat view						0.0

£ million		2015-16	2016-17	2017-18	2018-19	2019-20	Total
Total wholesale water legacy adjustments	Company view	-2.1	-2.1	-2.1	-2.1	-2.1	-10.4
	Ofwat view	-2.1	-2.1	-2.1	-2.1	-2.1	-10.3

Note:
Totals may not add up due to rounding.

These adjustments reflect our understanding of the company's performance using these incentives at the time of this draft determination. As part of the price review process the company is required to update its performance for 2013-14 and re-forecast its performance for 2014-15. We will reassess the company's performance in these years following that submission. Should its performance result in changes to the amounts arising from these incentive mechanisms (and the overall effect of all changes is material to price controls), then we will reflect these in our final determination. We will communicate any material changes in sufficient time for stakeholders to make appropriate representations on these matters before the final determination in December 2014.

Service incentive mechanism (SIM)

This draft determination includes the company's predicted legacy SIM reward/penalty of 0.0%.

It arrived at this prediction by comparing its actual SIM performance during 2011-12 and 2012-13 and its predicted performance in 2013-14, to the industry two-year average performance during 2011-13.

Table A23 above confirms the monetary amounts of the SIM adjustments.

Revenue correction mechanism (RCM)

For PR09, we introduced the RCM as part of the package to correct for differences between expected and actual tariff basket revenue between 2010 and 2015 at the 2014 Price Review. This mechanism provided companies with a financial incentive to encourage consumers to use water wisely. We confirmed the details of our revenue correction mechanism in 'PR09/31: Revenue correction mechanism' (July 2009).

Using the revenue correction mechanism that we described in our PR09 methodology paper, we will make an adjustment at this price review to take account of each company's revenue outperformance or underperformance relative to the assumptions we made in our final determinations for 2010-11 to 2014-15. This adjustment will be annualised over the five years in net present value (NPV) terms.

In 'IN 11/04: Simplifying the revenue correction mechanism', we summarised our decision to simplify two areas of the RCM; in particular, the 'billing incentive' and 'back billing'. The supporting information to this notice provides the technical detail to these changes.

This draft determination includes the company's RCM annualised adjustment amount as detailed in table A24 below. We have accepted the company's view of the RCM adjustments.

Table A24 RCM annualised adjustments to 2014 price review requirement

£ million		2015-16	2016-17	2017-18	2018-19	2019-20	Total
Water	Company view	0.5	0.5	0.5	0.5	0.5	2.5
	Ofwat view	0.5	0.5	0.5	0.5	0.5	2.5

Operating expenditure incentive allowance (OIA)

In accordance with the methodology set out in 'PR09/04: The opex incentive allowance and the outperformance multiplier for 2005-10', the company has not demonstrated year-on-year outperformance, needed to qualify for an incentive allowance in price controls. Table A25 below summarises the company's view and our view of the operating expenditure incentive allowances for 2015-20.

Table A25 Operating expenditure incentive allowance for 2015-20

£ million		2015-16	2016-17	2017-18	2018-19	2019-20	Total
Water service							
Incentive allowance (pre tax)	Company view	0.0	0.0	0.0	0.0	0.0	0.0
	Ofwat view	0.0	0.0	0.0	0.0	0.0	0.0
Incentive allowance (post tax)	Company view	0.0	0.0	0.0	0.0	0.0	0.0
	Ofwat view[4]	0.01	0.0	0.0	0.0	0.0	0.01

To calculate our view of its operating expenditure incentive allowance, we agreed with the company's assessment that no adjustments for logging up, logging down or

[4] Ofwat view is greater than the company view as we have corrected the error we made at PR09 in relation to logging up of metering opex.

shortfalls were necessary as it had provided sufficient evidence that it had delivered all of its FD09 outputs.

We note the entries the company made in this line in an attempt to correct for the error Ofwat made at PR09 that we refer to above. We consider it is more appropriate that this correction is made as a direct input to the overall incentive revenue allowance, rather than in the logging up and logging down adjustment line.

Our calculations indicate that at PR09, the former Veolia Southeast company should have received an incentive revenue allowance of £0.0216 million rather than £0.0111 million (post tax and in 2007-08 prices). We have therefore included £0.0123 million (that is, the difference of £0.0105 million indexed to 2012-13 prices) as a post-tax incentive revenue adjustment in 2015-16.

In our view, we accepted the company's atypical and exceptional cost adjustments to actual operating expenditure in 2009-10 and 2010-11. We also accepted its effective tax rate figure of 13.63% as this matched our records and was fully in line with the updated business plan guidance issued.

The company's adjustments for pensions did not match our analysis. Our risk-based review highlighted differing approaches by companies in calculating pension adjustments and we have set out our expectations for the revised business plans in 'Setting price controls for 2015-20 – further information on reconciling 2010-15 performance'. We expect the company to review the basis of its pension adjustments and be satisfied that these are fair and appropriate for the purposes of calculating any outperformance incentive allowance.

However, for the purposes of the risk-based review and this draft determination, we accepted the company's pension adjustments because substituting our view of what its pension adjustments might be did not change the overall result.

On receipt of the company's updated 2010-15 information in June 2014, we will update the analysis to take account of actual operating expenditure for 2013-14, the associated adjustments and the actual effective tax rate for 2013-14. We will also review in more detail the fairness and appropriateness of the company's pension adjustments in light of the 2013-14 actuals and its response to our feedback.

Finally, as confirmed in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', we are not implementing enhanced outperformance multipliers for the most efficient (frontier) companies in this price review.

Change protocol (logging up, logging down and shortfalls)

The change protocol for 2010-15 is a process by which a company can request a logging up of capex costs due to new or changed output obligations during the current price control period or a logging down of capex costs for outputs no longer required. We take account of the financial implications of these changes at the beginning of the next price control period. Where a company fails to deliver on time any outputs which are required and were included in price limit assumptions, a shortfall adjustment is made.

The company's business plan table W13 did not contain logging up, logging down or shortfall claims. Since the evidence the company provided in its business plan enabled us to confirm delivery of all its FD09 outputs, we have not initiated any additional counter claims.

We therefore support the company's view that:

- no adjustments are required to baseline capex included within the CIS reconciliation; and
- no adjustments are required to the FD09 opex assumptions in calculating any opex incentive revenue allowance.

Table A26 below summarises Affinity's view and our baseline view of total adjustments to capex included in the CIS reconciliation. These are expressed post efficiency and have been indexed to 2007-08 prices using the inflation measures from the company's business plan table A9.

Table A26 Summary of post efficiency capex for logging up, logging down and shortfalls included in the CIS reconciliation

2009-10 to 2014-15 £ million – post efficiency capex (2007-08 prices)	Water service	
	Company view	Ofwat view
Logging up (two sided)	0.0	0.0
Logging down (two sided)	0.0	0.0
Shortfalls (one sided)	0.0	0.0
Shortfalls for serviceability (one sided)	0.0	0.0

Table A28 Serviceability assessments for 2010-15[5]

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

On that basis, for the purposes of the risk-based review and this draft determination, we have not included any shortfall adjustments for serviceability. The revised business plan information requirements contain a specific table seeking more detailed information on the serviceability performance of the company's assets during 2010-15. We will therefore carry out a full review of this information, focussing on the company's updated actuals for 2013-14 and revised forecasts for 2014-15 and reassess our judgements if required.

Table A29 confirms the value and impact of any serviceability shortfall on the RCV.

Table A29 Impact of serviceability shortfalls on the RCV

2009-10 to 2014-15 £ million		Water
Amount subtracted from RCV (£ million)	Company view	0.0
	Ofwat view	0.0

The 2009 agreed overlap programme

The company proposed an overlap programme at PR09 relating to combined operational security which we agreed and made allowance for in 2009 price limits. Based on the information provided in the company's business plan, we have

[5] Assessments are based on actual and forecast performance submitted in Affinity's 2013 business plans.

Table A32 Water legacy true-up adjustments

	Incentive reward/(penalty) %		Reward/(penalty) £ million		Adjustment to 2015-20 revenue £ million		Adjustment to RCV £ million	
	Company view	Ofwat view	Company view	Ofwat view	Company view	Ofwat view	Company view	Ofwat view
Veolia Water Central	-4.7	-4.7	-16.4	-16.4	-6.6	-6.6	6.7	6.7
Veolia Water East	-3.9	-3.9	-0.5	-0.5	-0.5	-0.5	-1.0	-1.0
Veolia Water Southeast	-2.7	-2.7	-0.9	-0.9	-1.2	-1.2	-0.6	-0.6
Veolia Water Central	n/a	n/a	-17.8	-17.8	-8.2	-8.3	5.1	5.1

Note:
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.