

December 2014

Setting price controls for 2015-20
**Final price control determination notice:
company-specific appendix – Cholderton Water**



OFWAT

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Overview

This appendix sets out the details of the final determination of the price controls for Cholderton & District Water (Cholderton Water). As set out in '[Policy chapter A1 – introduction](#)' ('policy chapter A1'), this final determination protects customers in accordance with our statutory duties.

We published '[Draft price control determination notice: Cholderton Water](#)' (the 'draft determination' for Cholderton Water) on 26 September 2014.

In '[IN 13/18: 2014 price review – setting price controls for Cholderton and District Water for 2015-20](#)', we set out the approach we said we would take to setting price controls for Cholderton Water for the 2014 price review (PR14). Specifically, we confirmed that we would:

- not set separate wholesale and retail controls and, as a result, not use the average cost to serve or default tariff approach that form the basis of the retail controls for larger companies; and
- set a simplified control for Cholderton Water, using a process that includes a simpler business plan and a different approach for assessing its plan (from our 'risk-based review' of other companies).

Our approach reflects the small size of the company and our objective of applying the principles of best regulatory practice to be transparent, accountable, proportionate, consistent and targeted. For example, as part of this while we have expected the company to engage with its customer challenge group (CCG) to agree a suite of outcomes, we considered it disproportionate to require Cholderton Water to propose the incentives that it should receive for delivering its outcomes ('outcome delivery incentives'). Instead, we added performance commitments to the company's outcomes. We have held a number of meetings with the company to ensure that it understood the process and the information that we required to assess the company's plan.

This final determination sets out the K factors for Cholderton Water, along with what they mean for average customer bills. It also includes interventions that we have made to protect the interests of customers.

A1 Final determination – at a glance

In this section, we set out what the final 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 revenues it can recover, the efficient costs/expenditure we have assumed and the interventions we have made.

Average water bills and adjustment factors

Table A1.1 below sets out the average customer bills and adjustment factors in our final determination. We have also shown customer bills in 2012-13 prices for consistency with other companies. The adjustment factors set out here are consistent with those calculated for other companies. However, as explained in annex 1, Cholderton Water has different form of price control. We set out how the company should implement its price control in annex 1.

Cholderton Water's business plan was compiled using the company's view of 2014-15 prices so for revenue and costs, which are set out in subsequent tables, we have used that price base.

Table A1.1 Average water bills and K factors (2012-13 prices)

	2015-16 ¹	2016-17	2017-18	2018-19	2019-20
Adjustment factors					
Company plan	3.6	-0.1	-0.1	-0.1	-0.1
Ofwat draft determination	-2.2	-0.5	-0.3	-0.3	0.02
Company representation	-3.5	0.0	0.0	0.0	0.0
Ofwat final determination	-2.2	-0.5	-0.3	-0.3	0.0
Average bills – Ofwat draft determination (£)					
Unmetered household	211	209	209	208	208
Metered household	169	169	169	168	168
Total average household	197	195	194	193	193

¹ Year 1 Ks are shown for indicative purposes only. Annex 1 explains how our controls operate over 2015-20

	2015-16 ¹	2016-17	2017-18	2018-19	2019-20
Average bills – company representation (£)					
Unmetered household	216	216	216	217	217
Metered household	173	173	173	173	172
Total average household	201	200	200	199	199
Average bills – Ofwat final determination (£)					
Unmetered household	212	210	210	209	209
Metered household	169	169	169	168	168
Total average household	197	195	194	193	193

Allowed revenue and expenditure

The table below shows the expenditure we have allowed over the period from 2015 to 2020. The final determination allows Cholderton Water to receive revenues of £1,104,275.

Table A1.2 Allowed revenues (2014-15 prices)

	Draft determination	Company representation	Final determination
	£	£	£
Operating costs with efficiency savings	966,423	993,894	966,423
Capital expenditure	79,270	79,772	79,270
Bank interest	9,836	10,247	9,580
Final determination allowed revenue	1,014,531	1,037,330	1,014,275

The outcomes committed to by Cholderton Water

Cholderton Water has committed to delivering outcomes that reflect its customers' views. These are supported by associated performance commitments which we reflected in Cholderton Water's draft determination to specify the company's committed level of performance under each outcome. The company did not make any representations on the outcomes or associated performance commitments included in the draft determination, other than to state that their delivery is dependent upon the company having sufficient financial and operational resources.

As set out in IN 13/18, the company was not obliged to propose outcome delivery incentives. The company will be subject (from 1 April 2015) to the small company service incentive. We discuss our approach to outcomes in section 5.

Table A1.3 Outcomes, performance measures and performance commitments

Outcome	Performance measure	Reference year 2014-15	Performance commitment	Performance level 2019-20
Maintaining water quality	Mean zonal compliance	100%	100%	100%
Leakage reduction	Leakage in megalitres per day (MI/d)	0.24	0.22	0.17
Implementation of water efficiency measures	Meter penetration	31.9%	37.2%	49.5%
	Household per capita consumption in l/head/day	172	171	165
Limited infrastructure improvements	Number of supply interruptions	0	0	0
	Number of pump breakdowns	0	0	0

Summary of interventions

In reaching our final determination, we have intervened in the company's business plan where necessary to safeguard the interests of customers. In doing so, we have considered carefully representations we have received on the draft determination and taken account of the most up-to-date information available, where relevant. We summarise our interventions in the table below.

Outcomes	Costs and revenues
We have maintained the performance commitments associated with the company's outcomes as proposed in the draft determination.	We have maintained the 6% efficiency challenge to the cost forecasts made by Cholderton Water. This has resulted in a reduction in the allowed revenues over the period 2015-20 relative to the company's business plan.
Cost of borrowing	
We have applied an interest rate of 3.75% against the cost of Cholderton Water's borrowing – in this case, a bank overdraft – as opposed to the 3.85% applied in the draft determination.	

A2 Consideration of representations on our draft determination

We received two responses to Cholderton Water’s draft determination – one from the company itself, and one from the company’s CCG. We have fully considered the responses received in reaching our final determination.

The table below summarises the representations we have received on Cholderton Water’s draft determination and sets out where to find more information on our response in this document.

Table A2.1 Representations received on Cholderton Water’s draft determination

Area	Respondent	Detailed response in this company-specific appendix/Ofwat response
Efficiency challenge	Cholderton Water CCG	Section 3.1
Cost of borrowing	Cholderton Water CCG	Section 4
Outcomes and performance commitments	Cholderton Water CCG	Section 5

A3 Costs and expenditure

In this section, we set out our assessment of the proposed costs and expenditure included within Cholderton Water’s business plan and consider the representations made to Cholderton Water’s draft determination.

A3.1 Efficiency challenge

Table A3.1 Representations specific to the efficiency challenge for Cholderton Water

Respondent	Summary of comment	Ofwat response
Cholderton Water	<p>The company provided evidence that it had focused its efforts on operational expenditure and had reviewed every aspect of the company’s cost base to identify areas where savings could be made.</p> <p>The company identified savings in the following categories: lease of land, removal of costs in excess of RPI and miscellaneous savings (related to the costs of subcontracted labour). The company also negotiated a discount on the costs associated with its nitrate removal plant. The company stated that there was no further scope for savings in areas of salaries and electrical power costs.</p> <p>Overall, the company achieved a proposed 3.51% efficiency saving combined with a 3.85% reduction in sales income and stated that, given its already very low cost base, it was not possible to achieve a greater level of savings without seriously jeopardising the ability of the company to deliver its outcomes and meet its statutory</p>	<p>The proposed intervention that we made at draft determination was to set an efficiency challenge of 6%, taken from the relationship between the costs of average and upper quartile companies implied by our wholesale water total expenditure (totex) models, which is consistent with the challenge applied to other companies.</p> <p>We recognise that Cholderton Water was not included in those models explicitly. However, our assessments were based on the concept of a ‘notionally’ efficient company, taking account of the effects of a wide range cost drivers on the different appointees’ relative costs, including their relative sizes.</p> <p>We have a statutory duty to ensure that an efficient company is able to finance the proper carrying out of its functions. While the company has provided evidence to demonstrate that it is delivering efficiency savings to its customers, we remain of the view that a 6% efficiency challenge, implying additional savings of around £27,000 over the period, is achievable for an efficient company.</p>

Respondent	Summary of comment	Ofwat response
	obligations. Using these operational savings as a starting point, the revised financial forecast reduced the income from water sales receipts to a level where the cash flow is sufficient to maintain the overdraft at a level of not more than 24% of gross sales and no more than £60,000 in actual terms.	We therefore maintain the position as set out in the draft determination.
CCG	The CCG supports the company's actions in achieving the 3.51% savings and recognises that as a small company, Cholderton Water does not have the same flexibility in achieving cost savings as that of other water companies.	

A3.2 Capital expenditure

Table A3.2 Capital expenditure (2014-15 prices)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Ofwat draft determination	30,851	17,033	14,711	2,369	14,307	79,270
Company representation	31,043	17,141	14,804	2,384	14,397	79,772
Ofwat final determination	30,851	17,033	14,711	2,369	14,307	79,270

In line with our commitment to setting a simplified control for Cholderton Water, we have not utilised the cost models used for other companies to determine its cost threshold. Instead, we assessed the extent to which the company's plan provides a clear justification for the most material items of capital expenditure and areas of significant variance compared with the 2010-15 period. We have used a common set of criteria to assess the quality of the evidence provided, which is described in ['Setting price controls for 2015-20 – policy and information update'](#).

Overall, as set out in the draft determination, we are satisfied that the company has clearly explained the basis of its capital expenditure forecasts and note that, overall, it is forecasting a reduction compared with its expenditure in 2010-15, including a further discount on the costs of the nitrate removal plant negotiated since the draft determination which ensures that our estimates and the company's are now within around £500 over the whole period.

A3.3 Operating expenditure

Table A3.3 Operating expenditure (2014-15 prices)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total 2015-20
Ofwat draft determination	190,316	191,282	192,147	198,461	194,218	966,423
Company representation	196,864	197,310	197,635	203,612	198,473	993,894
Ofwat final determination	190,316	191,282	192,147	198,461	194,218	966,423

We have considered all of the company's projections for base operating expenditure submitted in the financial forecast for 2015-20 and its representation to our draft determination. The RPI +/- K framework ensures that the company's revenues will compensate for general changes in costs incurred by the economy as a whole. Indeed, as the company will benefit from indexation of the revenue allowed for its retail service activities due to the simpler form of control, it will be able to pass somewhat more of these risks onto customers than other water companies with separate price controls.

As set out above, our PR14 approach to Cholderton Water has not included the use of cost models to determine cost thresholds. However, on average, these cost models suggest an efficiency challenge of 6% for the improvement that an average company can make to move towards upper quartile efficiency in the wholesale water service, and, for the reasons outlined above, we do not consider it appropriate to apply a lower company-specific challenge to Cholderton Water for reasons of its relative size alone.

Therefore, in line with our approach to other companies, we have applied this level of efficiency challenge to Cholderton Water's final determination.

A4 Financial issues

Table A4.1 Representations specific to the cost of borrowing for Cholderton Water

Respondent	Summary of comment	Ofwat response
Cholderton Water	The company accepted the cost of borrowing (referred to as the weighted average cost of capital (WACC) in the draft determination) of 3.85% as applied in the draft determination, but stated that if the interest rate were to be revisited during the next five years then it should be borne in mind that the retail banking sector is the only realistic source of overdraft funding for a company of Cholderton Water's size.	In the draft determination, we included a cost of borrowing of 3.85% that was consistent with the cost of capital we used to calculate allowed returns for other small companies (who received a company-specific uplift). Latest market evidence of lower debt costs suggests that a corresponding rate would be lowered to 3.75%.
CCG	The CCG stated its concern if Ofwat applied a further reduction to the interest charge at final determination which impacted on the Company's ability to deliver service improvements to its customers.	Those companies who have received a company-specific uplift have been required to pass a 'benefits test', which we are unable to apply to Cholderton Water given the absence of separate price controls and the fact that we do not use the company's costs to benchmark other companies' efficient wholesale service costs. We have therefore reconsidered our position on the cost of borrowing to be applied to Cholderton Water and, to ensure consistency with other companies, we have applied an appointee-level interest rate of 3.75%. While this does not include an explicit uplift on the relevant costs for the wholesale service, it does include the return on the costs of retail services also being provided, which we estimate to be worth around the same. We note the comments of the company and CCG, but do not consider this reduction to be material

Respondent	Summary of comment	Ofwat response
		<p>(about £250 impact over the 2015-20 period) so as to compromise the company's ability to finance and carry out its functions efficiently.</p> <p>Our general policy relevant at an appointee level is set out in the 'Policy chapter A8 – financeability and affordability' ('policy chapter A8') that accompany our final determinations.</p>

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.

Cholderton Water's business plan is not based on a regulatory capital value; it instead shows a profit/loss forecast and balance sheet projection using its cost projections and projected overdraft interest payments. We accept that the company's close association with the Cholderton Estate enables the business to access finance from commercial banking sources, and the capital expenditure programme is expected to be financed by a bank overdraft.

The business plan submitted used a forecast interest rate based on the Lloyds Bank base rate. We have recalculated the interest charge based on a flat rate of 3.75%. This is consistent with the cost of capital which we have used to calculate the overall appointee-level return on capital allowed for other companies. Overall, this results in an interest charge that is £256 lower than the draft determination.

A5 Outcomes and performance commitments

Table A5.1 Representations specific to the outcomes and performance commitments for Cholderton Water

Respondent	Summary of comment	Ofwat response
Cholderton Water	The proposal to make the company's key outcomes complementary with the performance commitments is welcomed by the company. However, the company states that this is on the assumption that the company will have sufficient financial and operational resources to deliver the outcomes and performance commitments.	No change to draft determination.

Cholderton Water proposed four key outcomes to its CCG for the 2015-20 period. The company provided sufficient evidence in its business plan that it engaged effectively with its customers and that its proposals received a high degree of customer acceptance. In its report, the CCG expressed its support for Cholderton Water's business plan and acknowledged that the company had taken into account the views of its customers in its development.

The company's outcomes, performance measures and performance commitments are shown in table A1.3 in section A1. Performance levels have been taken from information stated in the company's draft water resources management plan or business plan, and the company has also confirmed them.

Although the number of performance measures is limited, they are well focused in that they cover the areas of high priority for the company's customers. It includes interruptions, leakage, unplanned breakdowns and water quality, which provides a good coverage of asset health and thus provides assurance that assets are being maintained, which also coincide with the measures most used by other companies .

The company's performance in these areas shall be monitored alongside the service incentive implemented for small companies .

The company did not propose any outcome delivery incentives and this is consistent with IN 13/18.

A6 Reconciling 2010-15 performance

In ‘[Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans](#)’ (our ‘final methodology statement’), we confirmed that we would make appropriate adjustments to allowed revenues for 2015-20, to reflect companies’ actual performance, costs and revenues when compared to our 2009 price review (PR09) assumptions.

We have concluded that the company’s actual performance was consistent with our PR09 assumptions and, therefore, no adjustments are necessary.

Annex 1 Detailed explanation of price control for 2015-20

Cholderton Water's licence is different from the other 18 water companies that are included in our final determinations. It sets out that the prices which Cholderton Water may charge for water services are limited by a formula which restricts the weighted average increase in charges in any year to the retail price index plus an Adjustment Factor (K) designed to take account of Cholderton Water's individual circumstances (the RPI+K formula).

The K factors to be used in this formula are set out below:

Charging year beginning 1 April	Adjustment factor
2015	-1.20
2016	-0.54
2017	-0.27
2018	-0.33
2019	0.02

Cholderton Water may wish to agree a licence modification to simplify our requirements and bring it into line with the other 18 water companies. If it had the same licence conditions the adjustment factor for the first year, 2015, would be zero, but the adjustment factors for the other four years would remain the same.

The table below shows Cholderton Water's revenue allowance as assumed in our determination converted to 2012-13 prices, which is consistent with our approach for determining the price controls for other companies in PR14.

For other companies we have set a K factor of zero for year 1 for wholesale revenue controls following the changes in these companies' licences for PR14. We have instead given the value of the revenue allowance for year 1 in a notional 2014-15 price base and applied the K factor of 0 to this allowance in this year. So companies will then inflate this figure by the change in RPI between November 2013 and November 2014 to give the allowance for 2015-16.

For consistency, this amount for 2015-16 for Cholderton is £209,784. If the company agreed to a licence modification, the company would then inflate this figure as described above when setting charges for that year. We have calculated that this would give it the same revenues as the current price control that we have set.

For subsequent years, the company would apply the K factor together with the preceding year's movement in actual November RPI.

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Revenue in 2012-13 prices		203,279	198,838	197,786	197,259	196,613	196,647
Ofwat final determination forecast RPI			265.769				
Revenue in forecast outturn prices			215,980				
November RPI	252.100	259.545					
Revenue in notional 2014-15 prices			209,784				

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Printed on 75% minimum de-inked post-consumer waste paper.
December 2014

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