December 2014

Setting price controls for 2015-20

Final price control determination notice: policy chapter A8 – financeability and affordability

Contents

Overview

This document sets out our approach to financeability and affordability in setting final determinations for the five years from 1 April 2015 and summarises the results of our review of representations received following publication of the draft determinations. The short and long term affordability of customer bills is central to delivering on our statutory duties including protection of customers. Enabling efficient companies to continue to finance their functions is important to both the longer term protection of customers and to our financing duty.

Consistent with our wider approach to this price review (PR14), we require companies to demonstrate that they are able to finance their functions, and that their plans are affordable both over the period 2015-20 and the longer term.

Our final determinations

Companies have engaged extensively with customers on the development of their business plans, demonstrating that there is a high level of customer support view that bills proposed in business plans were affordable. Our final determinations further reduce customer bills.

As a result of our final determination, average bills for water and wastewater customers in England and Wales will fall by around 5%, before adjustments for inflation, between 2015 and 2020. This would see average bills fall around £20 from £396 to £376.

Companies will also be doing much more to help customers who are struggling to pay their bills. Currently around 760,000 people benefit from some form of support from their water company. Over the next five years, companies are putting in place measures, such as social tariffs, which are forecast to help an additional one million people. These changes will more than double the number of people benefiting from financial support.

All companies provided board assurance and demonstrated that they were financeable on an actual and notional basis based on their business plans. We have confirmed that companies remain financeable on a notional basis following our interventions in their plans at final determination. These interventions have for example been to ensure that customers are only exposed to an efficient level of costs.

Our approach

As set out in our final methodology statement, we need to understand how the different price controls come together as an overall package, which may have a significant impact on customers through bills or companies and the financing of their functions. We therefore need to assess whether the business plans are financeable for the company as a whole and affordable for customers in the short and long term. Our approach to assessing financeability and affordability has the following key features:

- We interpret our statutory duty as securing that an efficient company can finance its functions.
- Company ownership of the financeability of plans, with companies providing board assurance, target credit ratings and credit ratios as evidence of their financeability.
- Ofwat assessment of evidence, including modelling companies' business plans and financial ratios on an efficient, notionally structured basis to ensure that risk around actual financing remains with equity holders and is not passed onto customers.
- Ofwat assessment of the impact of our interventions in company plans on financial ratios to confirm financeability on the basis of an efficient company in order to protect customers long term interests and consistent with our financing duty.
- Companies to demonstrate affordability of their plans, both in 2015-20 and in the longer term, to engage with customers to understand their affordability concerns, and to develop measures to mitigate affordability constraints of customers.
- Ofwat assessment of companies' evidence of the affordability of their plans, including their engagement with customers and the effectiveness of proposed actions to mitigate affordability issues.

- Ofwat assessment of companies' proposals to adjust 'pay as you go' (PAYG) rates (the proportion of totex recovered in the period 2015-20) and regulatory capital value (RCV) run-off rates (depreciation of the RCV). These rates change the proportion of costs recovered (and customer bills) within the 2015-20 period and the amount added to the RCV and recovered over a longer period. Our assessment is to minimise the risk to customers of any unintended consequences and to ensure their interests are protected.

Key changes since draft determinations

We have considered all representations carefully. A number of companies claimed their draft determination was not financeable, by which they meant that they would be unable to maintain their target investment grade credit rating. There were also challenges to the calculation of financeability ratios, tax and the accounting basis of our financeability assessment. Some companies considered that the notional approach to financeability meant that our assessment of financeability did not adequately reflect the impact of our wholesale totex, retail and legacy interventions and the calculations used by rating agencies. The four companies that were requested to provide third party assurance on their financeability at draft determination have provided this assurance in their representations

While we continue to consider that our approach is robust we have changed our assessment in the following areas.

- A change in our approach to the calculation of financial ratios for Severn Trent and United Utilities to take into account the differences between their tax and accounting treatment of Infrastructure Renewals Expenditure (IRE) within their business plans.

- Taking account of the impact of our interventions on the balance between operating and capital expenditure within the allowed totex, where our interventions on wholesale costs are greater than 5% or we received representations from companies that the change would have a material impact on financial ratios. This affects Southern Water (through changes to the water control) and United Utilities (through changes to the wastewater control), Bristol Water and South East Water.

- Detailed assessment of the further changes to PAYG and RCV run-off rates to ensure that changes since draft determination protect customers interests. We have intervened to reject companies proposed adjustment of PAYG and RCV run off rates since draft determinations for five companies due to insufficient evidence that changes to PAYG and RCV run-off rates have customer support and/or are proportionate to the customer benefits. For other companies we have intervened to ensure that the use of PAYG and RCV run off rates is proportionate for the notionally efficient company.

- Intervened to ensure that the profile of customer bills in 2015-20 is aligned with company and CCG representations. We have re-profiled customer bills for 17 companies so that they better reflect company and customer preferences.

A8.1. Introduction

In this policy chapter, we set out our approach to financeability (an efficient company's ability to finance its functions) and affordability (customer bills, both today and in the future) in setting the final determinations for the five years from 1 April 2015. We summarise the results of our review of companies' business plans and how we have responded to the issues raised by representations to our draft determinations.

This introduction:

- sets out the structure of this policy chapter; and
- describes the development and refinement of our approach to financeability and affordability.

A8.1.1 Document structure

In section A8.1.2 below, we describe the development and refinement of our approach to financeability and affordability.

In the remainder of this policy chapter, we then explain this approach.

- Section A8.2 considers companies' financeability, considering board assurance, financial modelling and ratios, tax and use of PAYG and RCV run-off rates

- Section A8.3 considers affordability over the 2015-20 period and in the longer term, including the profiling of customer bills.

Within each section, we outline:

- our proposed policy position as set out in our draft determinations;
- the key issues raised by the representations received to our draft determinations; and
- our final position.

Consistent with the final policy position set out in this chapter, we set out our company-specific consideration of financeability and affordability in the relevant company-specific appendices.

We will also publish the financial and feeder models, which contain the detailed calculations for each company, alongside this determination.

We discuss our approach to risk and reward in ‘Policy chapter A7 – risk and reward’ (the ‘risk and reward policy chapter’).

A8.1.2 Our approach

Both financeability and affordability are important for how Ofwat and companies meet their statutory and legal obligations.

We set out the key features of our proposed approach to financeability and affordability in July 2013 in ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (our ‘final methodology statement’). We set out that we would:

- assess whether plans taken as a whole are financeable and affordable;
- assess financeability (and financial ratios) at an appointee level based on an efficient company with our notional capital structure, assessing whether individual controls are self-financing in their own right;
- allow companies to adjust PAYG and RCV run-off rates to assist financeability and manage affordability by balancing recovery of cost between 2015-20 and future periods;
- assess whether proposals represent a fair balance between the interests of the company and its customers, including the degree to which the company has demonstrated it has reflected customer views in its adjustment to PAYG and RCV run-off rates;
- ensure companies took ownership and provided board assurance of the financeability of their business plans; and
- assess affordability over 2015-20 period and in the longer term, and on companies’ response to customer concerns about affordability of the business plan

Companies first submitted their business plan proposals to us in December 2013. In January, we issued our risk and reward guidance setting out our view of the appropriate cost of capital, and as a result we did not assess the risk and reward and financeability elements of company business plans as part of the risk-based review (RBR), except for the pre-qualified companies. In the RBR we provided feedback to all companies on affordability.

We assessed the risk and reward and financeability elements of the business plans of South West Water and Affinity Water, who prequalified for enhancement, adjusted only to reflect their acceptance of the risk and reward guidance. All other companies submitted revised business plans reflecting the Ofwat risk and reward guidance alongside other revisions to their plans, and provided board assurance and demonstration of their financeability and affordability.

In response to the risk and reward guidance, most companies passed through some of the WACC reduction to customers in 2010-15, resulting in lower bills, while some also offset part of the WACC reduction by adjusting PAYG and RCV run-off rates to manage financeability. In these circumstances customers in the longer term will benefit from the current (historically) low financing costs.

Companies also took account of our RBR feedback on affordability and provided better evidence of the affordability of their plans and their engagement with customers. In the draft determination consultation, we asked a number of companies to engage with their customers and demonstrate support for adjustments to PAYG and RCV run-off rates.

Since we published our final methodology statement, we have issued additional policy documents relevant to financeability and affordability to explain our approach in more detail, as shown in the table below.

Table A8.1 Additional policy documents published relevant to financeability and affordability

Document name	Publication date	Description/policy content
'Setting price controls for 2015-20 – risk and reward guidance' (our 'risk and reward guidance')	January 2014	Guidance on wholesale WACC, retail margins, ODI, uncertainty mechanisms and RoRE range.
'Setting price controls for 2015-20 – pre-qualification decisions'	March 2014	Overview of RBR test applied for affordability and companies' performance against these tests.
'2014 price review risk-based review – internal methodology' (our 'RBR internal methodology')	April 2014	Sets out the principles applied when scoring the RBR tests and criteria. Describes our detailed assessment methodology for each of our RBR tests.
Enhanced companies draft determinations	April 2014	Assessment of financeability and affordability for enhanced companies.

Document name	Publication date	Description/policy content
'IN 14/11: 2014 price review – Ofwat's approach to assessing financeability' (our 'information notice on financeability')	May 2014	Sets out further information for companies on the evidence of financeability we require them to submit as part of their business plan submissions in June.
'Setting price controls for 2015-20, Draft price control determination notice: technical appendix A7 – financeability and affordability' ('the financeability and affordability technical appendix to our August draft determinations')	August 2014	Sets out our approach to financeability and affordability for the August draft determinations, consistent with our risk and reward guidance.

Details of company-specific affordability and financeability interventions in our draft determinations can be found in the relevant company-specific appendices to our draft determinations published in April, May and August.

A8.2. Financeability

A8.2.1 Introduction

We carry out our powers to fulfil our statutory duties. These include (among other things) to secure that a company is able to finance the proper carrying out of its functions. We interpret this financing duty as requiring that we ensure that an efficient company with a notional capital structure is able to finance its functions. A company's actual capital structure is a choice for the company and it bears the risk associated with its choices.

Consistent with our final methodology statement, we considered financeability before adjustments to revenues that reflect performance over 2010-15, to ensure that our focus is on financeability for the 2015-20 period and that companies take responsibility for performance in previous periods. It is based on an efficient company, which assumes that companies are able to deliver their plans based on the expenditure allowance in our final determination.

Our focus is on the financeability of the company with a notional capital structure as this ensures that risks around financing decisions, such as the level of gearing and structure of debt, remain with shareholders in the company rather than being passed on to customers. This is in line with our principle that risk should be allocated to whoever is best placed to manage it. In principle, if efficient companies can earn 'reasonable' returns over a price control period on the component parts of the appointed business, their overall financeability should be secure. In practice, financeability challenges can still arise from timing mismatches between required and actual cashflows within individual years.

As set out in our final methodology statement and our May 2014 information notice on financeability, we asked companies to demonstrate that they can finance their activities by providing financial ratios in their business plans at the appointee level on an actual and notional capital structure (with gearing and cost of debt consistent with our financial guidance and a 33% weighting of index-linked debt). We also asked companies to explain how these ratios are consistent with their target credit ratings and invited them to provide additional evidence on financeability, such as third party assurance or evidence from rating agencies and lenders.

It can be appropriate for the company to consider the use of PAYG and RCV run-off rates to address financial constraints that would affect the notional company, if they exist. Changes to PAYG and RCV run-off rates will impact on customer bills, so we asked companies to explain to their customers and CCGs their proposed changes since draft determination and how they propose to balance the company's financeability requirements and customers' interests.

We do not consider it appropriate for the company to use PAYG and RCV run-off rates to address financeability issues arising from the actual financing arrangements of a company. For example, a company more highly geared than the notional company gearing of 62.5% may experience financeability issues that would not affect the notional company. This is an issue for the company's shareholders to address (such as through a reduction in, or suspension of, dividends and/or equity injections). It may in some circumstances be beneficial to customers for a company to maintain a particular credit rating and so lower longer-term borrowing costs; however, it would still only be appropriate to use changes in PAYG and RCV run-off rates to maintain notional credit ratios to support this rating. It would not be appropriate to use PAYG to support target ratios for the actual capital structure, as this would mean that customers bear risk from companies' financing decisions.

As we stated in our final methodology statement, we assess how companies have demonstrated their financeability by considering:

- financeability (and financial ratios) at a whole company level – using aggregated revenues, costs and cash flows associated with efficient delivery of regulated activities across all the price controls;
- whether proposals for controls are self-financing in their own right; and
- whether proposals represent a fair balance between the interests of the company and its customers.

The next sections set out our assessment of companies' evidence of their financeability.

- Section A8.2.2 considers board assurance of companies' financeability.
- Section A8.2.3 discusses financial modelling and financeability ratios.
- Section A8.2.4 discusses tax
- Section A8.2.4 considers evidence of customer support and benefits for the use of PAYG rates and RCV run-off rates for financeability.

A8.2.2 Board assurance on financeability

A8.2.2.1 Our draft determinations

We summarised our proposed approach to assessing companies' board assurance of financeability in the relevant draft determination documents, including in section A7.2.1 of the financeability and affordability technical appendix to our August draft determinations. Thames Water and United Utilities provided third party assurance on the financeability of their revised business plans. Dŵr Cymru provided additional assurance on the financeability of its business plan in response to Ofwat concern at tightness of ratios in its revised business plan.

All companies provided board assurance that their plans were financeable on an actual and notional basis. In our draft determination, we asked four companies to provide additional third party assurance on financeability because of serious issues with the quality of the financial information presented in their plans and, in two cases, concerns about individual ratios.

Table A8.2 Further assurance on financeability required in draft determinations

Companies	Requirement
Dee Valley Water and South Staffordshire Water	Third party assurance on financeability and calculation of the financial ratios.
Portsmouth Water	To consider financeability of actual company (consistent with licence obligation) in light of their revisions to calculations of ratios, which materially reduce their funds from operations (FFO)/debt ratio, and to provide third party assurance on their financeability and calculation of financial ratios.
Sutton & East Surrey Water	To consider financeability in the light of draft determination interventions, in particular with regard to the adjusted cash interest cover ratio (ACICR), which is materially lower than proposed in their business plan (due to their approach to calculation), and to provide third party assurance on their financeability and calculation of financial ratios.

Each of the four companies that we asked to provide further board and third party assurance did so as part of their draft determination representations.

A8.2.2.2 Our final determination

We have reviewed the assurance provided by each of the companies and consider that it addresses our earlier concerns and that the companies involved have appropriately considered their own financeability.

During this review, further issues were identified with Dee Valley Water's assurance. While these issues were subsequently resolved, we will take them into consideration in the context of the further assurance we will require going forward.

A8.2.3 Financial modelling and ratios

A8.2.3.1 Our draft determinations

We summarised the approach that we had adopted in considering companies' financeability ratios in the relevant draft determination documents, including in section A7.2 of the financeability and affordability technical appendix to our August draft determinations.

As part of the price review we have developed a financial model to help us assess companies' business plans. The main purpose of the financial model is to determine the wholesale price controls, to calculate the revenues arising from the retail price controls and to assess the financeability of the appointee.

Apart from the enhanced companies and the companies that received their draft determinations in May, our draft determinations were based on version 6 of the financial model, which was published in June 2014. This included additional functionality, input adjustments (to assist data input and use) and refinements (for example to financial ratio and debtor day calculations).

Our draft determinations set out the results of our financial modelling of company draft determinations for four financial ratios. These ratios are similar to those used by credit rating agencies; however, we note that rating agencies consider a range of evidence in the assessment of credit ratings and do not rely on the ratios alone. Rating agencies may also place different weights on various ratios and use alternative ratios or define ratios differently. Rating agencies are concerned with financeability of the actual company, including expenditure which Ofwat considers is inefficient and has not allowed for in its final determination.

Consistent with our final methodology statement, we considered financeability before adjustments to revenues that reflect performance over 2010-15, to ensure focus on underlying financeability, and based on an efficient notional company, which assumes that companies are able to deliver their plans based on the expenditure allowance.

A8.2.3.2 Issues raised by representations

Thirteen companies raised issues on financeability and financial modelling. These are summarised in the table below.

Table A8.3 Representations on financeability and financial modelling

Issue	Description of issue	Companies
Treatment of infrastructure renewals expenditure (IRE)	The calculation of financial ratios should align with the level of IRE expensed under International Financial Reporting Standards (IFRS) accounting	Severn Trent Water, United Utilities
Capex/opex split	The split of totex between capital and operating cost for the purpose of modelling financial statements and calculating ratios does not reflect the underlying split due to Ofwat's draft determination interventions. Failure to reflect appropriate level of operating cost results in overstatement of financial ratios.	United Utilities, South East Water
Financial ratio formula and/or adjustments	Ofwat's approach to calculating financial ratios is not consistent with the approach used by rating agencies.	Anglian Water, Severn Trent Water, Thames Water, United Utilities, Bristol Water, Sutton & East Surrey Water, South East Water
Impact on financeability from draft determination interventions	Ofwat's interventions (for example on totex, legacy adjustment or ODI penalties and rewards) make the draft determinations unfinanceable as they would not be able to maintain their target credit rating or their expected return on equity.	Anglian Water, Northumbrian Water, Southern Water, Severn Trent Water, Wessex Water, Bristol Water

Issue	Description of issue	Companies
Impact on actual financeability	The draft determinations are unfinanceable based on the company's actual financial structure.	Severn Trent, Southern Water, United Utilities, Bristol Water, South East Water
Household retail unfinanceable	The household retail control is unfinanceable due to the scale of cost challenge assumed by Ofwat.	South West Water, Sembcorp Bournemouth Water, Thames Water, Wessex Water
Incorrect treatment of capital income and totex	The company considered that in the draft determination: • capital income had been netted off twice from the wholesale revenue requirements due to the company's incorrect interpretation of the business plan tables (£24m impact over 2015-20); • wholesale water totex was overstated by £1.5 million due to an incorrect sign in the financial model; and • the wholesale WACC in the financial model was incorrectly stated as 3.6975% instead of 3.70%.	Dŵr Cymru
Omission of PR09 adjustment	Northumbrian Water pointed out that we omitted an adjustment for an error made at PR09 relating to the Dagenham supply pipe scheme, amounting to £14.3 million.	Northumbrian Water

A8.2.3.3 Our final determinations

The calculation of financial ratios

We have considered representations on financeability and have amended our approach in two areas.

- **Treatment of infrastructure renewals expenditure (IRE):** we have calculated financial ratios for Severn Trent Water and United Utilities assuming 100% of IRE is expensed, in line with IFRS accounting treatment (other companies have not identified differences between their accounting and tax treatment of IRE expenditure).

- **Capex/opex split:** Taking account of the impact of our interventions on the balance between operating and capital expenditure within the allowed totex, where our interventions on wholesale costs are greater than 5% or we received representations from companies and change would have a material impact on financial ratios. This affects Southern Water (through changes to the water control) and United Utilities (through changes to the wastewater control), Bristol Water and South East Water

Table A8.4 Our response to representations on financeability

Issue raised	What we did	Why we did it
Treatment of IRE	Change our approach to calculate financial ratios under both approaches for Severn Trent Water and United Utilities.	Severn Trent Water and United Utilities have provided sufficient evidence that the proportion of IRE expensed under IFRS will be 100% rather than the 75% (for Severn Trent Water) and 89% (for United Utilities) assumed in the draft determinations. This change will adversely affect financial ratios. No other companies have made representations on this issue.
Capex/opex split	Amend split of totex between opex/capex for purpose of financeability modelling where our wholesale cost interventions are greater than 5% of totex.	At draft determinations, we used company business plan assumptions for the totex split between opex and capex to model financial statements. However, for some companies our interventions are more likely to remove capex rather than opex. This would adversely affect ratios. We have amended our approach for companies with a greater than 5% difference in control totex. This covers Bristol Water, Southern Water (water) and United Utilities (wastewater).

Issue raised	What we did	Why we did it
Financial ratio formula and/or adjustments	No change.	Each of the rating agencies has their own approach to calculating financial ratios, which differ between agencies and change over time and relate to the actual rather than notional company. We consider our financial ratio calculations provide an appropriate basis for assessing the financeability of an efficient company for the purpose of setting price controls.
Impact on financeability from draft determination interventions	No change.	Financeability should be assessed pre-legacy adjustments based on an efficient notional company – that is, Ofwat's view of allowed totex and ACTS, consistent with the established approach that we (and the Competition Commission) have used previously. It is for companies to manage any impact arising from inefficient costs or legacy adjustments. This includes menu adjustment for additional income, as this reflects menu position and inefficiency relative to allowed totex.
Impact on actual financeability	No change.	Consistent with our methodology and the approach used that we and other regulators have used previously, we assess financeability on a notional basis for an efficient company. It is for companies to decide on their actual capital structure and to bear the consequences of such decision.

Issue raised	What we did	Why we did it
Household retail unfinanceable because our cost assumptions are not achievable and/or the recovery of pre-2015 retail depreciation in the wholesale water and wastewater RCV means that retail revenues are insufficient .	Continue to use standalone retail financeability test.	Consistent with our approach elsewhere, retail financeability should be assessed on the basis of an efficient operator. We have run our stand-alone retail financeability test and consider the retail control is financeable.
Incorrect treatment of capital income and totex	Correct treatment of capital income and totex. Use wholesale WACC of 3.60% in financial model	We have made adjustments for Dŵr Cymru error in business table submissions and the use of an incorrect sign in the model. We have taken account of the updated WACC in the financial model and round to two decimal places.
Omission of PR09 adjustment	Include Dagenham scheme in Northumbrian Water final determination	We have made an adjustment to include the Dagenham scheme in the final determination to correct for omission from PR09 final determination.

A8.2.4 Taxation

Allowed revenues need to be sufficient to cover the efficient costs faced by companies including taxes. The forecast level of taxation is calculated by the financial model, based on the companies' expected revenues and costs. This section sets out our approach to calculating taxation for the draft determinations, the representations on these calculations and the changes we have made in our final determinations

A8.2.4.1 Our draft determinations

In the draft determinations we set the allowed revenues of the wholesale controls to include the recovery of the appropriate level of taxation (for retail controls the taxation allowance is included in the margin). To help achieve this aim, wholesale tax has first been calculated at the wholesale level for both services combined, where applicable, and then apportioned to the water and wastewater services for the separate allowed revenues concerned. As set out in our final methodology statement, our approach to calculating tax is similar to the method used for PR09, but with a simplified and less data-intensive approach.

The corporation tax paid by water and sewerage companies depends both on the profits they make and on the tax relief they claim for:

- investments in certain types of assets (capital allowances); and
- interest payments on debt used to finance their activities.

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

We based the tax calculation on projected corporation tax rates, profits and assumed levels of tax relief. We took 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.

A8.2.4.2 Issues raised by representations

Five companies raised issues around the modelling of taxation:

- Severn Trent Water on the treatment of deferred tax credits;
- United Utilities on differences between actual and notional tax;
- Affinity Water on differences in tax liability;
- Sutton & East Surrey Water on tax treatment of preferences shares and issuance costs; and
- South Staffordshire Water on tax treatment of bond refinancing.

In addition, Severn Trent and Wessex Water provided evidence on CCG support for their proposed treatment of an expected tax credit following agreement with HMRC over the treatment of expenditure water and sewerage treatment works. We had allowed the company's proposed approach at draft determination, but asked them to engage with their CCGs and their obtain support.

A8.2.4.3 Our final determinations

Table A8.5 sets out our assessment of company representations. In general these issues were specific to the company's involved and are discussed in more detail in the company specific appendices. We have accepted Severn Trent Water's and Wessex Water's use of the tax credit, Affinity Water's revised tax liability and Sutton & East Surrey's issuance costs.

Table A8.5 Assessment of representations on taxation

Company	Issue raised	What we did	Why we did it
Seven Trent Water and Wessex Water	Both companies provided evidence that they had engaged with their CCG and received its agreement on their proposed use of an expected tax credit.	Allow proposed use of tax credit.	Given the support of the CCGs we have accepted Severn Trent Water and Wessex Water's proposals
Severn Trent Water	There are errors in the calculation of tax in the index-linked debt macro model.	No change.	We have checked the model and we are content it is working correctly.
United Utilities	The draft determination forecasts tax paid in 2015-16 as zero, however the company forecasts tax payments in 2015-16 will be around £50 million.	Do not allow change.	Taxation allowances are based on modelled calculations and do not reflect actual tax (if higher than notional).
Affinity Water	Affinity Water noted a variance of £4.4 million in tax liability relating to our treatment of income from infrastructure charges as an offset against capital expenditure rather than revenue (which is required by IFRS accounting).	Allow change.	We consider that the revised tax inputs Affinity Water provided after the draft determination are consistent with the rest of its plan and have used them in the financial modelling for final determination.

Company	Issue raised	What we did	Why we did it
Sutton & East Surrey Water	For accounting purposes preference share dividends are treated as debt, they are not, however, tax deductible and therefore need to be added back to taxable profits to determine the appropriate tax charge. The company pre-paid issuance costs for its £100 million Index Linked Bond and is amortising the issuance costs over the life of the Bond at £442k a year. These costs should be included in interest costs as they are tax deductible.	Allow change for issuance costs but not tax adjustment for preference shares.	The tax adjustment for preference shares is not required as our financial model treats preference share dividends as not tax deductible. We agree that issuance costs should be included as interest costs and so have reflected this in the final determination.
South Staffordshire Water	In their revised business plan South Staffordshire included an adjustment for additional tax charges associated with the re-financing of a bond in 2005-06. We did not include the adjustment in the draft determination as the company did not explain why an adjustment relating to additional tax paid over the period of 2005-06 to 2015-16 is appropriate in 2015-16 or how customers have benefited. South Staffordshire Water stated that we should allow the adjustment as customers have benefitted from the company being more financially stable.	Do not allow additional tax charge.	We have retained our position at draft determination of not funding the additional tax charges for bond refinancing. We disallowed this adjustment at PR09 as the company remained in a tax neutral position following the accounting change. The company has not provided any further relevant information that would cause us to change our view.

A8.2.5 Adjusting cost recovery from customers to address financeability

A8.2.5.1 Our draft determinations

For the first time we have allowed companies to propose their own PAYG and RCV run-off rates. In the past, these have been the outcome of a regulatory process (operating cost allowance and allowed depreciations rates). These tools are important as they allow a company to manage the amount of money that they collect from their customers today versus money that they collect in the longer term and are important to enable the benefits of a totex approach to be realised for customers. As we set out in our final methodology statement adjustments to these rates can help companies manage both financeability for the notional structure and affordability issues.

In our draft determinations, we considered companies' PAYG and RCV run-off rates. In particular we examined how some companies adjusted their PAYG and RCV run-off rates since their December plans, which had the effect of offsetting part of the benefits of the WACC reduction to customers in the period 2015-20.

To assess company PAYG and RCV run-off rates, we considered whether:

- the company's financial ratios were materially better than financeability requirements;
- the company had used PAYG/RCV run-off rates to offset the reduction in the cost of capital since December 2013; and
- there was customer support for the company's use of PAYG/RCV run-off rates.

Table A8.6 sets out, for the companies for which we intervened in our draft determinations, our requirements and interventions on the use of PAYG and RCV run-off rates. We also required companies that made changes to PAYG/RCV run-off rates between their December and revised plans to engage with their customers and explain why this was in customers' best interests.

Table A8.6 Draft determination interventions and requirements on the use of PAYG and RCV run-off rates

Company	Interventions and requirements
Yorkshire Water	We reset PAYG/RCV run-off levels to those in the December plan as the company had used PAYG and RCV run-off rates to remove all of the impact of the WACC reduction in 2015-20 in its revised business plan, in order to support financeability of the actual rather than notional company and with little evidence that this approach was beneficial to customers and limited CCG engagement.
Sembcorp Bournemouth Water	We reset PAYG based on the average of opex and IRE in the period, as the company had used a high PAYG ratio in 2015-20 (in relation to 2020-25) to maintain stable bills over the 2015-25 period. The company's approach increased bills over the 2015-20 period with little evidence that this approach was beneficial or informed by support from its customers.
Anglian Water, Severn Trent Water, Southern Water, United Utilities and Wessex Water	We required these companies to re-engage with their customers to gain informed support on the customer benefits from the use of financeability tools.

A8.2.5.2 Issues raised by representations

Five companies proposed changes to PAYG and RCV run-off rates in their submissions for financeability reasons. These companies's issues can be broadly grouped as follows:

- to improve financeability and to partially mitigate the loss of allowed revenue between June plan and draft determinations (Anglian Water, Southern Water, Severn Trent Water); or
- to reflect changes in the wholesale cost baseline which impacts the split of operating and capital expenditure which adversely affect financeability (United Utilities and South East Water).

Company representations on the use of PAYG and RCV run-off rates in respect of financeability are set out in Table A8.7. In addition, Northumbrian Water made a change to increase its PAYG rate and reduce its RCV run-off rate which is financially neutral in the period 2015-20. Seven companies also proposed changes to PAYG and RCV run-off rates to smooth bills. These are considered under affordability (section 8.4).

Table A8.7 Company proposed changes to PAYG and RCV run-off rates

Company	Company proposed changes to PAYG and RCV run-off rates	Ofwat calculation of total revenue impact 2015-20
Anglian Water	To improve financeability and to partially mitigate the loss of allowed revenue between June plan and draft determinations.	£104m
Southern Water	To improve financeability; and partially mitigate loss of allowed revenue between June plan and draft determinations due to Ofwat interventions on totex, legacy and retail.	£44m+
Severn Trent Water	To improve financeability; in particular, to maintain an S&P BBB+ rating by targeting an S&P FFO/debt ratio of 9% to 10%.	£142m
United Utilities	To improve financeability; in particular, to maintain a S&P BBB+ rating by targeting an S&P FFO/debt ratio of 9% to 10% and to take account of changes in the balance of totex split between capital and operating expenditures and impact on financial ratios.	£182m
South East Water	To improve financeability; in particular, to maintain an S&P BBB rating by targeting an S&P FFO/debt ratio of above 8% and to take account of changes in the balance of totex split between capital and operating and impact on financial ratios. South East also proposed that these adjustments would help smooth bills between 2015-20 and 2020-25.	£28m

Company	Company proposed changes to PAYG and RCV run-off rates	Ofwat calculation of total revenue impact 2015-20
Bristol Water	Late representation proposing to adjust the PAYG rate to maintain an S&P FFO/debt level of 10% to 11%, based on actual company with adjustment for efficient level of costs. In particular, Bristol is targeting customer bill with a minimum of £178 in 2015-16 with glide-path down to efficient costs in three years.	£42m
CCWater	Companies should not use PAYG to buffer themselves against a lower cost of capital at the expense of customers either now or in the future	n/a

Note:

Anglian Water proposed changes for both financeability and customer bill profile reasons.

Amounts calculated in Ofwat financial model based on company submissions of PAYG/RCV run off adjustments relevant to final determination totex allowances.

A8.2.5.3 Our final determinations

We understand CCWater's concerns that companies might use cost recovery rates to buffer themselves against a lower cost of capital at the expense of customers in the 2015-20 period. We therefore consider that it is important that companies engage with customers and demonstrate they are acting in customers' best interest when adjusting PAYG and RCV run-off rates since draft determinations. Consequently, we have used the following four criteria to assess whether the use of PAYG and RCV rates to bring forward revenue to 2015-20 is appropriate.

- **Quality of customer engagement:** for example, the type of survey, sample size and CCG support.
- **Basis of engagement:** in particular, the 2015-25 bill profiles presented to customers and how this reflects their business plan.
- **Proportionality:** whether the adjustment is proportional to the financeability or customer requirement.

- **Evidence of net benefits:** whether there is evidence of benefits to customers such as benefits from lower cost of debt in future price controls from maintaining credit ratings.

Based on this assessment, we consider that we should:

- Partially allow the PAYG/RCV run-off adjustment for Severn Trent Water, United Utilities and South East Water as this additional revenue is required for them to meet target ratios in their June business plan on a notional basis and they have provided evidence of long term benefit to customers. A key difference between our calculation of FFO/debt and the S&P calculation is that S&P remove the benefits of index-linked debt. We have calculated a notional FFO/debt taking account of the S&P adjustment, and have confirmed that all of these companies would lie below their target ratios without adjustment to PAYG and RCV run-off rates.

- Disallow the adjustment for Southern Water and Anglian Water as these changes are not required to maintain notional target financeability ratios.

- We have also allowed Northumbrian Water's revenue-neutral proposal to increase its PAYG and reduce its RCV run-off as the net impact of the change does not impact on the balance of revenue recovered between 2015-20 and in the longer term and therefore additional customer engagement is not required.

We have taken account that Bristol Water's forecast allowed revenue for 2014-15 will need to fall from around £121 million (forecast for 2014-15) to £100 million in 2015-16 based on our view of efficient costs. As part of their representations Bristol requested adjustments to PAYG rates that would have reduced the impact of the decline and would have generated allowed revenues of £110 million in 2015-16. As part of our financeability assessment we considered a high cost scenario, where Bristol are assumed to spend 50% of the difference between their view of wholesale totex (excluding costs associated with Cheddar Two) and our view of efficient costs for 2015-16. We calculated revenues of £107 million in 2015-16 would be required to recover the costs under this scenario.

We consider that financeability should be assessed on the basis of an efficient company. However, we have considered whether it would be appropriate to allow Bristol Water to bring forward limited revenue to the 2015-20 period to allow it time to adjust to the new lower revenue and bills. We have only considered this given the scale of the totex challenge and bill reduction that Bristol Water's final determination delivers, and remain of the view that our standard approach of placing responsibility for cost out and underperformance with equity holders is in the best interest of customers.

Bristol Water proposed that it should be given a three-year glide-path to achieve efficient costs by bringing revenue forward. We do not consider that this is appropriate, as little evidence is provided to justify the length of the glide-path and the glide-path does not reach the Ofwat view of efficient costs by 2018-19.

- Based on no glide-path, Bristol's financeability ratios based on a notional capital structure but with costs as set out in the high cost scenario, are unlikely to be financeable and fall below Bristol Water's target credit ratios (with 2015-16 ratios of FFO/debt 7.6% and ACICR below 1.0). We therefore consider a glide-path is required, as it would be reasonable to assume that Bristol does not make full cost reduction required in first year.

- Based on a one-year glide-path, with allowed revenue of £107 million in 2015-16 but reaching Ofwat's view of efficient costs in 2016-17, Bristol Water is financeable on the basis of a notional company with costs as set out in the high cost scenario (2015-16 FFO/debt 13% and ACICR 1.6).

We do not consider a two-year glide-path is required as it would not be reasonable to assume that Bristol could not reduce costs by 2016-17 substantially toward efficient levels and there is some headroom in their notional ratios to accommodate cost under-performance. It is appropriate for equity holders to take responsibility for failure to significantly reduce costs to efficient levels.

Based on the above information, we have allowed Bristol Water a one-year glide-path with changes to PAYG rates to increase 2015-16 revenue by £7 million.

Table A8.8 Summary assessment of company proposed changes to PAYG and RCV run-off rates for financeability

Company	Quality of engagement	Basis of engagement	Proportionality	Evidence of net benefits	Overall assessment
Anglian Water	Partial pass	Partial pass	Fail	Fail	Reject proposal. Final determination financeability ratios are consistent with ratios in June business plan.
Southern Water	Partial pass	Fail	Fail	Fail	Southern Water only engaged on 2015-20 profile. Reject proposed change as Southern is using PAYG to address actual financeability issues and little evidence to support high level of rating target (11% FFO/debt).
Severn Trent Water	Pass	Pass	Partial pass	Pass	Accept part of the proposed PAYG change (£99 million/£142 million) as well supported by customer engagement and notional S&P ratio below 9%-10% target. We have provided sufficient revenue to take the FFO/debt ratio to within 9%-10% range (taking account of S&P treatment of index linked debt) for the notional company. Severn Trent Water engaged with its customers and obtained their support for bringing forward revenue to maintain its credit rating. Evidence of costs and benefits to customers.

Company	Quality of engagement	Basis of engagement	Proportionality	Evidence of net benefits	Overall assessment
United Utilities	Pass	Partial pass	Partial pass	Partial pass	Accept part of the proposed PAYG change (£156 million/£182 million) as supported by customer engagement and notional S&P ratio below 9%-10% target. We have provided sufficient revenue to take the FFO/debt ratio to within 9%-10% range (taking account of S&P treatment of index linked debt) for the notional company. Some evidence of customer benefits from bringing forward revenue.
South East Water	Partial pass	Partial pass	Partial pass	Partial pass	South East Water engaged with its CCG and did not undertake new customer surveys. Accept part of proposed PAYG change (£19 million/£28 million) as notional S&P ratio below 8% target. We have provided sufficient revenue to take the FFO/debt ratio to above 8% (taking account of S&P treatment of index linked debt) for the notional company. Some evidence of customer benefits from bringing forward revenue.
Bristol Water	Fail	Fail	Fail	Fail	Based on the extent of totex challenge and bill reduction rather than evidence provided by the company we have introduced a one year glide-path to reach the Ofwat level of efficient cost to provide time for company to make the significant cost reduction and address any concerns around notional financeability.

Note: Green indicates that the criterion was met; amber indicates that the criterion was partially met; and red indicates the criterion was not met. Further details in company specific annexes.

A8.2.6 Financeability ratios

Table A8.9 summarises the results of our financial modelling of company final determinations for five financial ratios. We defined these ratios in our final methodology statement. As set out in that statement, financial ratios are based on an efficient notional company and are before adjustments to reflect performance over 2010-15, as this reflects the company's underlying financeability.

As discussed in section A8.2.4, five companies (Anglian Water, Southern Water, Severn Trent Water, United Utilities and South East Water) stated that our draft determinations were unfinanceable and proposed to use financeability tools (PAYG and RCV run-off rates) to bring forward revenues to 2015-20.

Three other companies (Northumbrian Water, Wessex Water and Bristol Water) stated that the draft determinations were unfinanceable and proposed significant changes. Northumbrian Water was concerned about the balance of risk and reward relating to interventions on the outcome delivery incentives. Wessex Water was concerned about the impact of our interventions on wholesale and retail costs. Bristol Water was concerned about the impact of the draft determination on allowed expenditure. Bristol Water made a late representation proposing to adjust PAYG rates to bring revenue forward to address financeability arising from impacts of Ofwat's interventions in their plan.

For three of these companies (Severn Trent Water, United Utilities and South East Water) we have accepted part of their proposed PAYG changes to ensure that these companies can maintain target credit rating for notional company. We have also adjusted Bristol Water's PAYG rate to provide a transition path to efficient level of costs by 2016-17.

Table A8.9 Ofwat calculation of selected financial ratios for the notional capital structure for final determinations

Company	ANH	NES	SRN	SVT[1]	SWT	TMS	UU[1]	WSH	WSX
ICR	2.88	3.54	3.44	3.12	3.08	2.84	3.28	2.54	3.30
ACICR	1.46	1.84	1.46	1.55	1.53	1.40	1.65	1.59	1.78
FFO/debt	8.57%	11.48%	11.08%	9.60%	9.74%	8.43%	10.25%	6.97%	10.44%
RCF/debt	5.98%	8.84%	8.42%	6.97%	7.11%	5.92%	7.53%	4.41%	7.84%
Gearing	62.62%	62.01%	62.02%	63.09%	62.04%	64.58%	59.83%	62.52%	63.93%
Company	**YKY**	**AFW**	**BRL**	**DVW**	**PRT**	**SBW**	**SES**	**SEW**	**SSC**
ICR	3.03	3.56	3.63	3.33	2.68	3.32	3.46	3.03	3.70
ACICR	1.65	2.17	1.69	1.52	1.33	1.90	1.19	1.76	1.51
FFO/debt	9.20%	12.08%	12.07%	10.87%	8.04%	11.08%	11.23%	9.20%	12.31%
RCF/debt	6.59%	9.51%	9.41%	8.43%	5.45%	8.45%	8.62%	6.61%	9.68%
Gearing	60.49%	63.49%	64.89%	67.59%	62.23%	61.32%	65.51%	62.94%	67.21%

Key:

ANH = Anglian Water; SRN = Southern Water; SVT = Severn Trent Water, TMS = Thames Water; UU = United Utilities; WSX = Wessex Water; BRL = Bristol Water; DVW = Dee Valley Water; PRT = Portsmouth Water; SBW = Sembcorp Bournemouth Water; SES = Sutton & East Surrey Water; SEW = South East Water; SSC = South Staffordshire Water.

Note:

[1]Financial ratios for Severn Trent and United Utilities assume 100% of IRE is expensed. RCF = retained cash flow.

A8.3. Affordability

Customer bills are a key element of the relationship between companies and their customers. Companies engaged extensively with customers on the development of their plans, including demonstrating that there is a high level of customer support for the affordability of bills. Our final determinations have reduced bills r since the December plans, further improving the affordability of business plans. Overall, our final determinations result in water and wastewater bills 5% lower on average in 2019-20 compared with 2014-15

Companies will also be doing more to help customers who are struggling to pay their bills. Currently around 760,000 people benefit from some form of support from their water company. Over the next five years companies are putting in place additional measures which are forecast to help a further one million people. This focus on assisting people to pay their bills will be reinforced by the approach that we are taking in the retail controls where we have only allowed adjustments for bad debt driven by deprivation that are beyond efficient management control.

In this section, we:

- discuss our assessment of affordability and present the impact of our final determinations on customer bills (section A8.4.1); and
- consider the profile of bills over the 2015-20 period (section A8.4.2).

A8.3.1 Assessment of affordability

As set out in our final methodology statement, our approach to affordability has been to assess how well companies have demonstrated their plans are affordable both over the period 2015-20 and the longer term.

A8.3.1.1 Our draft determinations

We set out our assessment of the affordability of companies' proposals for the draft determinations in the relevant draft determinations documents, including in section A7.3 of the financeability and affordability technical appendix to our August draft determinations.

In assessing current and future affordability for our draft determinations, we considered:

- company evidence on affordability from customer surveys, customer acceptability scores and CCG engagement;
- companies' identification, based on their evidence, of affordability issues for customers and the development of appropriate measures to address the affordability issues for these customers;
- the impact on bills in 2015-20 and in the future from the use of financeability rates to bring forward or push back revenue between price control periods; and
- the potential impact of ODI penalties and rewards on affordability.

In our draft determinations we stated that many companies provided strong evidence of engaging customers over the acceptability of plans and proposed bill levels, with companies proposing a range of measures to address customers' concerns on affordability.

The six companies where we had identified concerns in the RBR with the evidence provided on the affordability of their December business plans (Bristol Water, Dee Valley Water, South East Water, South Staffordshire Water, Sutton & East Surrey Water and Thames Water) responded positively in their revised business plans. The one company we required to further work in our draft determinations was Sutton & East Surrey Water, which we asked to work with its CCG and Thames Water to establish an ongoing communications programme to inform customers of the effects of the Thames Tideway Tunnel (TTT) on their bills.

A8.3.1.2 Issues raised by representations

Sutton & East Surrey Water provided evidence that it is working with Thames Water on stakeholder engagement on the impact of the Thames Tideway Tunnel on customer bills and would continue to work with Thames Water on an overall approach as well as specific key messages.

CCWater carried out new research into customer acceptability of the bills in the draft determinations. This research was split into three areas.

- Uninformed acceptability, which was based on the percentage changes on current bills.

- Uninformed plus, which was based on the bills level in monetary terms (including and excluding inflation).

- Informed acceptability, where customers were told of the service levels expected of the water companies in the 2015-20 period.

CCWater does not consider the results of its work is comparable to company affordability research on their business plans and considers that as it follows a consistent survey approach across all companies it should enable greater comparability between companies.

Table A8.10 Comparison of CCWater and company acceptability research

Company	Company research (business plans)	CCWater research (draft determinations)		
		Uninformed	Uninformed+	Informed
Anglian Water	90%	82%	64%	64%
Northumbrian Water	75%	54%	45%	50%
Southern Water	90%	69%	51%	55%
Severn Trent Water	88%	74%	56%	66%
South West Water	84%	73%	44%	50%*
Thames Water	85% w/o TTT (59% with)	72%	41%	50%
United Utilities	75%	76%	53%	61%
Dŵr Cymru	95%	71%	53%	58%
Wessex Water	81%	78%	55%	67%
Yorkshire Water	77%	78%	55%	58%
Affinity Water	87%	77%	67%	67%
Bristol Water	90%	79%	80%	72%
Dee Valley Water	75%	76%	68%	69%
Portsmouth Water	99%	78%	62%	74%*
Sembcorp Bournemouth Water	79%	84%	83%	85%*
Sutton & East Surrey Water	84%	71%	60%	59%
South East Water	49%	71%	70%	63%
South Staffordshire Water	87%	72%	61%	63%

Note:

Acceptability based on combined water and wastewater bills except for Portsmouth Water and Sembcorp Bournemouth Water which were based on water only as the combined results were not reported. South West Water bills did not take account of the Government's £50 per year subsidy. CCWater acceptability results sourced from final version of 'Customers' views on Ofwat's draft determinations for process and service 2015-20' October 2014.

A8.3.1.3 Our final determinations

We consider that Sutton & East Surrey Water has provided sufficient and convincing evidence that it has met our draft determination requirement and begun to work with Thames Water on its communication programme.

We have reviewed CCWater's research and consider it is helpful to have comparative survey results across companies. We also agree with CCWater that the results are not directly comparable with company results. There are some notable differences including the timing (draft determination versus business plan), methodology (online versus face to face and telephone surveys), treatment of real and nominal bills and information on company outcomes and service delivery. As noted above, the results of CCWater's survey for Portsmouth Water and Sembcorp Bournemouth Water only includes the water bill, while for South West Water it excludes the Government £50 subsidy, which impacts on the comparability of results between companies.

We consider that the CCWater survey results emphasise the need for companies to continue to engage with customers on an on-going basis.

Consistent with our PR14 methodology, the customer acceptability research that companies carried out was not simply aimed at finding overall acceptability, but to provide input to shape the scope and scale of business plans as well as to identify different types of customers that might have specific affordability concerns. We have required companies to demonstrate the affordability of their plans, to engage with customers to understand their affordability concerns, and to develop measures to mitigate affordability constraints of customers. As part of their business plans, companies put forward a variety of affordability measures to address the concerns of customers. Companies proposed a significant extension of these measures.

Table A8.11 sets out the financial assistance measures proposed by companies and the forecast increase in coverage. Overall (excluding Water Direct which does not provide discounts) companies have stated that they will increase coverage of financial assistance measures by around 445,000 households, or around 1 million people, to 1.8 million people. The most significant increase in coverage comes from the introduction of social tariff schemes where all companies are either planning to have a scheme or a scheme is in development (Yorkshire Water, Dee Valley Water and Portsmouth Water). Companies are also forecasting increases to the provision of debt advice, flexible payment plans and water efficiency audits. Further details are set out in the company specific appendices.

Table A8.11 Overview of affordability measures proposed by companies

Measure	Description	Increase in coverage by 2019-20 (households)
WaterSure	WaterSure is a statutory scheme available for certain customers with a water meter which allows them to have their bills capped.	+34,000
Water Direct	Water Direct is a scheme run by the Department for Work and Pensions (DWP) where payment for water bills is deducted directly from benefits.	+14,000
Social Tariff	Specified groups of customers facing financial hardship, which meet certain criteria, receive cross-subsidised discounts to their bills.	+349,000
Win-win tariff	A reduced tariff which does not impact on other customers' bills because the reductions are funded through savings such as lower debt recovery costs.	-24,000
Write-off scheme	Customers in arrears with their water company, who meet certain criteria, have a proportion of their debt written off by the company.	+56,000
Trust fund/hardship fund	These schemes offer financial help to customers who are in debt to their water company. They are normally run independently of the water company and can provide a new start to customers who have found themselves in debt to their water company.	+6,000
Other	Including Aquacare plus (Anglian Water) and local authority discount tariff.	+24,000
Total	**Excludes Water direct**	**+459,000**

A8.3.2 Bill profiles

The bill profile is important as it represents how customers' bills will change over the period 2015-20 and takes account of the change in allowed revenues and change in customer numbers. The PAYG and RCV run-off rates will affect the bill profile either; by allowing bills to be smoothed in period (by altering cost recovery on an annual basis) or; by allowing the company to bring forward (or push back) revenue between periods. The choice of bill profile and cost recovery rate is therefore a core element of the relationship between the company and its customers. We have reviewed the bill profile proposals by companies and only intervened where we do not consider that customer interests are being protected, for example there is not informed customer support for bring forward revenue to the 2015-20 period.

A8.3.2.1 Our draft determinations

We considered the results of our interventions on the bill profile for each company in the relevant draft determination documents, including in section A7.4 of the financeability and affordability technical appendix to our August draft determinations.

Our interventions in companies' business plans, such as reducing allowed totex, will protect customers' interests. These interventions will also affect both the level and profile of bills over the 2015-20 period. In the draft determinations we considered the bill profile for each company and re-profiled where our interventions resulted in significant changes in the bill level, as the company's proposed bill profile may no longer be relevant. We re-profiled on the basis of company evidence of customer preferences but due to the scale and nature of adjustments for some companies, further engagement was needed to understand customer preferences. We stated that we expected all companies to engage with their customers on bill profiles from the draft determinations and provide evidence of customer support for any changes. Table A8.12 shows a summary of our draft determination bill profile.

Table A8.12 Draft determination bill profile interventions

Company	Intervention
Southern Water, United Utilities, Wessex Water, Yorkshire Water, Bristol Water, Dee Valley Water, South East Water, South Staffordshire Water.	We re-profiled to take bill reduction in the first year with broadly flat bills for the remainder of the period to equalise customer benefits across the period and avoid the risk of an unduly low bill at the end of the period with consequent implications for bill changes in the 2020-25 period.
Portsmouth Water	We re-profiled to provide a flat bill profile consistent with the Portsmouth Water business plan by removing the decrease in 2015-16 and subsequent increase in 2016-17 that resulted from the initial draft determination model run.

A8.3.2.2 Issues raised by representations

Sixteen companies provided representations on bill profiles. Of these:

- four companies (Anglian Water, Thames Water, Yorkshire Water and Sembcorp Bournemouth Water) proposed using PAYG and RCV run-off rates to smooth bills between 2015-20 and beyond;
- two companies proposed to use PAYG to smooth bills in the 2015-20 period (Dee Valley Water and Sutton & East Surrey Water); and
- the remaining companies made representations on their preferred profile within the 2015-20 period (following engagement with their CCG) but did not suggest using PAYG to achieve this.

Table A8.13 Company proposed changes to PAYG and RCV run-off rates for bill profiling

Company	Company proposed changes to PAYG and RCV run-off rates	Ofwat calculation of total revenue impact 2015-20
Anglian Water	To ensure smooth bills between 2015-20 and 2020-25.	£104m
Thames Water	To ensure smooth bills between 2015-20 and 2020-25 (in particular to take into account Tideway).	£250m

Company	Company proposed changes to PAYG and RCV run-off rates	Ofwat calculation of total revenue impact 2015-20
Yorkshire Water	To ensure smooth bills between 2015-20 and 2020-30.	£108m
Sembcorp Bournemouth Water	To ensure smooth bills between 2015-20 and 2020-25.	£5m
Dee Valley Water	To smooth bills within the 2015-20 period.	Nil
Sutton & East Surrey Water	To smooth bills within the 2015-20 period.	Nil

Note:

Anglian Water proposed changes for both financeability and customer preference reasons. Amounts calculated based on company representations on proposed changes taking account of Ofwat interventions at final determination.

A8.3.2.3 Our final determinations

It is particularly important that any changes to PAYG and RCV run-off rates since draft determination are based on engagement with customers and reflect their long term interest, as changes will affect customer bills set in draft determination both in 2015-20 and over the long term.

We have therefore assessed the companies that proposed to use PAYG and RCV run-off changes to smooth bills over 2015-20 and beyond against our assessment criteria: quality and basis of engagement, proportionality and evidence of net benefits.

Based on this assessment, set out in Table A8.14, we have accepted the proposed revenue adjustment by one company, Yorkshire Water, although we have amended the proposal to increase the RCV run-off rate consistent with its view that its RCV run-off rate was below the economic level of depreciation for its regulatory assets.

We do not consider that there is sufficient evidence to accept the other companies' proposals (Thames Water, Anglian Water and Sembcorp Bournemouth Water) and have amended bill profiles in 2015-20 to smooth any adjustment to the next control period.

Table A8.14 Company proposed changes to PAYG and RCV run-off rates

Company	Quality of engagement	Basis of engagement	Proportionality	Evidence of net benefits	Overall assessment
Anglian Water	Partial pass	Fail	Fail	Fail	Reject as insufficient evidence of informed customer support and concerns can be addressed by bill-profiling in period. In particular, we are concerned that Anglian Water's customer engagement overstated the impact on customer bills in 2020-25 of a higher RCV of £98 million in 2020 and so undermines the evidence of customer support for their proposed adjustment to RCV run-off rates. We consider that Anglian customer preference for flat bills can be best met by reprofiling in the 2015-20 period to provide a first year price reduction and flat bills over the period.
Thames Water	Partial pass	Fail	Fail	Fail	Reject as PAYG change is based on smoothing overstated 2020 bills and concerns over profile can be addressed by bill smoothing in-period. In particular, we are concerned that Thames Water's engagement on customer bills overstated 2020-25 bills for Thames (excluding Infrastructure Provider (IP)) and used maximum IP bills and so overstated likely bill increase in 2020-21. Taking account of a more realistic range of future bills suggests there is not compelling evidence of significant bill increase in 2020-21 in the absence of bill smoothing. We consider that Thames Water's evidence of customer support for smoothing bill can be

Company	Quality of engagement	Basis of engagement	Proportionality	Evidence of net benefits	Overall assessment
					best met by reprofiling bills in 2015-20.
Yorkshire Water	Pass	Partial pass	Partial pass	Pass	Accept as well supported by customer engagement (which examined preferences of both overall and hard to reach customers on a range of bill profiles). In addition, there is evidence that the December business plan and draft determination would delay cost recovery and so result in future bill increases in the absence of change in the RCV run-off rate.
Sembcorp Bourne-mouth Water	Pass	Fail	Fail	Fail	Reject as insufficient evidence of informed customer support and concerns can be addressed by bill profiling in period. We consider that the company's engagement is likely to overstate bill increases in 2020-21 and customer preferences for flat bills are best met by profiling in 2015-25 period.

Note: Green indicates that the criterion was met; amber indicates that the criterion was partially met; and red indicates the criterion was not met. Further details in company specific annexes.

We consider that the choice of bill profile is a key element of engagement between the company and its customers. Our final determination interventions can result in significant changes to the bill profile proposed by companies. Given the importance of the company owning the customer relationship we have generally re-profiled bills in the 2015-20 consistent with the companies representations.

The exception to this approach is where companies had proposed to bring forward revenue to 2015-20 but where we rejected a large part or all of their proposal (Anglian Water, Thames Water, and Sembcorp Bournemouth Water). In this case, we have taken account of their concerns about potential increases in 2020 by setting flat bill profiles and avoiding unduly low bills at the end of the period due to the impact of bill profiling. Our reprofiling of bills (or our allowance for bringing forward revenue) should not be taken as an indication of our views of the potential profile of bills in future control periods, which will be based on the prevailing circumstances at the time.

Table A8.15 Our interventions on bill profiles

Company	Intervention on bill profile
South West Water and Affinity Water	As enhanced companies we have targeted their preferred bill/revenue profile.
Sutton & East Surrey Water	None.
Dŵr Cymru , Southern Water, Thames Water	Gradual decline.
Bristol Water	One year glide-path and then flat bills.
Dee Valley Water and Portsmouth Water	Broadly flat.
Anglian Water, Northumbrian Water, Severn Trent Water, United Utilities, Yorkshire Water, Wessex Water, Sembcorp Bournemouth Water, South East Water and South Staffordshire Water	Reduction in the first year and then broadly flat.

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

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