



Paul Butler
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12 December 2014

Dear Paul

Final determination of price controls

I enclose the formal notification of the determination by the Water Services Regulation Authority (Ofwat) of Price Controls for Retail Activities and for Wholesale Activities. This sets out:

- the designation of Retail Activities;
- the Price Controls in respect of Retail Activities;
- the Price Control in respect of Wholesale Activities; and
- (in the attached annex) the Notified Item and Land sales assumptions.

We will publish information about the annual regulatory reporting and assurance requirements early in 2015.

This final determination letter has been published on our website. We are also publishing the outcomes and associated performance commitments for the company to deliver, together with information on our general approach and the reasons for our decisions.

A key feature of our price review has been clarity about the outcomes that you will deliver and the performance commitments that you have set out. So while not part of the detail set out in the enclosed notification, the set of outcomes, performance commitments and outcome delivery incentives (as detailed in Annex 4 to the published appendix that is specific to your company) should be seen as an essential part of both the price review package and what you need to deliver for your customers.

Cathryn Ross, Chief Executive

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You must notify us of your menu choice by 16 January 2015 (see IN 14/15, '2014 price review – timetable for setting charges for 2015-16 and making menu choices' (September 2014)).

You have two months from today to decide whether to ask us to refer the determination to the Competition and Markets Authority. If you wish to refer the determination you must let us know in writing no later than 12 February 2015.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C. Ross', with a stylized flourish at the end.

Cathryn Ross
Chief Executive

Notification by the Water Services Regulation Authority of its determination of Price Controls for Retail Activities and for Wholesale Activities for South East Water Limited (“the Determination”)

Introduction

This is the Determination by the Water Services Regulation Authority (“Ofwat”) as to the Price Controls for Retail Activities and for Wholesale Activities. It is made by Ofwat in accordance with Part III of Condition B (Charges) of your Appointment as a water undertaker, having had regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991, including, without limitation:

- any change in circumstance which has occurred since the last Periodic Review or which is to occur; and
- the guidance issued by the Secretary of State for Environment, Food and Rural Affairs under section 2A of the Water Industry Act 1991.

The Price Controls will apply to the Charging Year starting on 1 April 2015 and subsequent Charging Years.

You must levy charges in a way best calculated to comply with the Price Controls.

Unless the contrary intention appears, words and expressions used in this document shall have the same meaning as in the Conditions of the Appointment.

Designation of Retail Activities

For the purposes of the Determination, Ofwat confirms the designation under subparagraph 8.9 of Condition B of (in summary) the following activities and costs as Retail Activities:

Customer services including:

- billing;
- payment handling;
- remittance and cash handling;
- charitable trust donations;
- vulnerable customer schemes; and
- network and non-network customer enquiries and complaints.

Debt management and doubtful debts.

Meter reading.

Other operating costs including:

- decision and administration of disconnections and reconnections;
- demand-side water efficiency initiatives;
- customer-side leaks;
- attributable other direct costs;
- attributable general and support expenditure; and
- attributable other business activities.

Developer services:

- providing developer information; and
- administration for new connections.

Attributable Business Rates (referred to as Local authority rates in Regulatory Accounting Guideline (RAG) 4.04).

These are, with one change, the retail activities summarised in Table 1 of ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (July 2013) and defined in more detail in section A5.4 of Appendix 5 (Guidance on business plan tables) to that document. The one change is that our definition of Retail Activities was subsequently updated to exclude all scientific services (see IN 13/10, ‘Change to company business plan guidance for the 2014 price review – costs of scientific services’ (September 2013)).

All activities undertaken as part of the Appointed Business that are not designated as Retail Activities are Wholesale Activities.

This designation is treated for the purposes of sub-paragraph 15.1 (References to the Competition and Markets Authority) of Condition B as part of the Determination.

Price Control for Wholesale Activities

In respect of the Appointed Business’s Wholesale Activities, except those activities for which there are Excluded Charges, for the five consecutive Charging Years starting on 1 April 2015 there shall be one single Price Control.

Such Price Control shall consist of, in each Charging Year:

- the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Retail Prices Index between the published for the month of November in the Prior Year and that published for the immediately preceding November; and
- a number, "**K**", which may be a positive number or a negative number or zero

which together shall be expressed as a percentage, and which shall limit the change in the revenue allowed to the Appointed Business in each Charging Year in respect of the Wholesale Activities concerned.

For the purpose of this Price Control, the revenue in respect of the Wholesale Activities concerned includes capital contributions such as cash receipts from connection and infrastructure charges (including requisitions and self lay).

For each Charging Year starting on or after 1 April 2016 the revenue allowed to the Appointed Business in respect of the Wholesale Activities concerned will be the product of the following formula:

$$R_t = R_{t-1} \times (1 + (RPI + K_t)/100)$$

Where:

R_t = Revenue allowed to the Appointed Business in Charging Year t;

R_{t-1} = Revenue allowed to the Appointed Business in the Prior Year;

RPI + K_t = a number which is the sum of:

- (i) the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Retail Prices Index between that published for the month of November in the Prior Year and that published for the immediately preceding November; and
- (ii) a number, "**K_t**" for Charging Year t, which may be a positive number or a negative number or zero.

For the Charging Year starting on 1 April 2015 the revenue allowed to the Appointed Business in respect of the Wholesale Activities concerned is the product of the same formula except that **R_{t-1}** = the relevant revenue allowance (as set out below). This is because (as the form of Price Controls has since changed) at the last Periodic Review no revenue allowance in respect of Wholesale Activities was set for the Charging Year that started on 1 April 2014.

The starting point for the calculation of the change in the revenue allowed to the Appointed Business in the Charging Year starting on 1 April 2015 (the wholesale water revenue allowance) is £193.278 million. The “K” numbers for each Charging Year are set out in Table 1.

Table 1 Water services “K” numbers

Charging Year beginning 1 April	K
2015	0.00
2016	1.29
2017	0.87
2018	0.58
2019	0.58

Note:

There is no Table 2 in this Determination. This is a deliberate omission that ensures consistency in Table numbers between water undertakers and water and sewerage undertakers.

Price Controls for Retail Activities

In respect of the Appointed Business’s Retail Activities, Ofwat has decided that there shall be:

- one single Price Control in respect of the Appointed Business’s Household Retail Activities; and
- one single Price Control in respect of the Appointed Business’s Non-household Retail Activities.

For the purposes of the Determination:

- **“households”** has the same meaning as:
 - (i) the regulatory reporting definition of that term set out in section A5.4 of Appendix 5 (Guidance on business plan tables) to ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (July 2013); or (if different)
 - (ii) such definition as may be included in Regulatory Accounting Guidelines issued under paragraph 5 of Condition F (Accounts and accounting information) of the Appointment;
- **“Household Retail Activities”** means Retail Activities relating to the supply of water to households;

- “**Non-household Retail Activities**” means Retail Activities relating to the supply of water to premises other than households;
- “**metered**” means that all or some of the charges for a supply of water are based on measured quantities of volume; and
- “**unmetered**” means that none of the charges for a supply of water are based on measured quantities of volume.

Price Control for Household Retail Activities

The Price Control for Household Retail Activities:

- shall consist of a limit on the total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned; and
- is set for a period of five consecutive Charging Years starting on 1 April 2015.

The total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned (Household retail allowed revenue) shall be the relevant amount set out in Table 3 as modified in accordance with the following formula:

Revenue modification for charging year y

$$= \sum_{c=1}^2 (\text{actual customer numbers}_{y,c} - \text{forecast customer numbers}_{y,c}) \cdot \text{modification factor}_{y,c}$$

Where:

y = Charging Year;

c = customer type (unmetered water only, metered water only);

“**customer numbers**” means the average number of individual households supplied or served by the Appointed Business in a Charging Year; and

“**forecast customer numbers**” and “**modification factors**” are set out in Tables 4 and 5.

Table 3 Household retail allowed revenue

Charging Year beginning 1 April	£million
2015	20.355
2016	20.951
2017	21.535
2018	21.992
2019	22.680

Note:

There is no Table 2 in this Determination. This is a deliberate omission that ensures consistency in Table numbers between water undertakers and water and sewerage undertakers.

Table 4 Household retail allowed revenue modification factors by class of customer (£/customer)

	Revenue modification per:	2015-16	2016-17	2017-18	2018-19	2019-20
1	Unmetered water only customer	19.10	19.48	19.87	20.16	20.45
2	Metered water only customer	26.44	26.48	26.54	26.49	26.78

Table 5 Forecast customer numbers for household retail allowed revenue (thousands)

	Number of customers	2015-16	2016-17	2017-18	2018-19	2019-20
1	Unmetered water only	237.654	199.321	161.966	125.099	88.720
2	Metered water only	598.142	644.552	690.288	734.942	779.060

Price Control for Non-household Retail Activities

The Price Control for Non-household Retail Activities:

- consists of limits on the average revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned for specific customer types;
- is set for a period of two consecutive Charging Years starting on 1 April 2015;

- does not impose any limit on the revenue allowed to the Appointed Business in respect of the Retail Activities concerned where a customer freely chooses to pay different charges to those that they would otherwise be liable for; and
- does not impose any limit on any revenue in respect of Retail Activities from Excluded Charges, charges (including charges for developer services) that are not Standard Charges or any miscellaneous charges that are not directly related to the supply of water.

The total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned for a specific customer type shall not exceed R calculated in accordance with the following formula:

$$R = [(r_c \times c_n) + w] / (1 - m) - w$$

Where:

r_c = the allowed average retail cost component for a given customer type (in pounds) as set out in Table 6;

c_n = the customer numbers for a given customer type;

w = the wholesale revenue for a given customer type; and

m = the allowed net margin for a given customer type (expressed as a percentage) as set out in Table 6.

For the purposes of the Price Control for Non-household Retail Activities:

- a “**customer type**” is a class of customers described in Table 6 by reference to the type of charge (known as a default tariff), fixed by or in accordance with a charges scheme under section 143 of the Water Industry Act 1991 or agreements with the persons to be charged, that is payable by them for any water supply provided by the Appointee;
- “**customer numbers**” means the average number of individual premises supplied or served by the Appointed Business in a Charging Year; and
- “**wholesale revenue**” means the revenue that the Appointee recovers in a Charging Year in respect of Wholesale Activities relating to the supply of water to premises other than households (assuming for these purposes that the Appointee offered itself no more favourable terms in relation to payment than would be offered to any other person in respect of Wholesale Activities).

Table 6 Non-household customer types, allowed average retail cost components and allowed net margins

Customer type	Term (units)	2015-16	2016-17	2017-18	2018-19	2019-20
[over 250Mla] [water] [metered/unmetered]	r _c (£)	141.65	139.46	136.76	133.68	131.24
	m (%)	2.3%	2.3%	2.3%	2.3%	2.3%
[50-250Mla] [water] [metered]	r _c (£)	152.01	149.67	146.77	143.47	140.85
	m (%)	2.3%	2.3%	2.3%	2.3%	2.3%
[10-50Mla] [water] [metered]	r _c (£)	79.32	78.10	76.59	74.86	73.50
	m (%)	2.3%	2.3%	2.3%	2.3%	2.3%
[5-10Mla] [water] [metered]	r _c (£)	74.37	73.22	71.80	70.18	68.90
	m (%)	2.3%	2.3%	2.3%	2.3%	2.3%
[0-5Mla] [water] [metered]	r _c (£)	38.94	38.10	37.13	36.08	35.19
	m (%)	2.8%	2.8%	2.8%	2.8%	2.8%
[water] [metered/unmetered]	r _c (£)	33.46	32.76	31.95	31.08	30.33
	m (%)	0.5%	0.6%	0.6%	0.6%	0.6%

Demonstrating Compliance

In September 2014 Ofwat published a consultation on proposals for an integrated annual regulatory report that would be one of the ways in which the Appointee would demonstrate compliance with the Price Controls. We will publish information about the annual regulatory reporting and assurance requirements that will apply to the Appointee early in 2015.

Annex: Notified Item and Land Sales

Notified Item: Water Business Rates

For the purposes of the Determination Ofwat gives notice that it has not allowed in full for the effect from 1 April 2017 on the Appointed Business of the coming into force on 1 April 2017 of a new central non-domestic rating list in relation to water supply hereditaments to the extent that the effect could not have been avoided by prudent management action.

This Notified Item is a two-way Notified Item: that is, Ofwat may instigate an interim determination or, if the Appointee instigates an interim determination, Ofwat may take into account any effect on the Appointed Business whether favourable or unfavourable for the Appointee.

The costs or savings attributable to this Notified Item shall for each relevant Charging Year comprise the product of the following formula for the Appointee:

(Water Business Rate Sharing Rate – Menu Cost Sharing Rate) X (Applicable Water Business Rate Costs_t – (Water Business Rate Cost Allowance_t X Menu Choice Expenditure Factor))

For the purposes of this Notified Item:

Words and expressions used in this Notified Item have the same meaning as in the Conditions of the Appointment unless the contrary intention appears.

“**Water Business Rates**” means the rateable value determined under the Local Government Finance Act 1988 of water supply hereditaments used wholly or mainly for the purposes of a water undertaker or for ancillary purposes as shown in the central rating list;

“**central rating list**” shall be construed in accordance with section 52(1) of the Local Government Finance Act 1988;

“**water supply hereditaments**” means the hereditaments described:

- in relation to England, in regulation 15(1) of the Central Rating List (England) Regulations 2005 (SI 2005/551); and
- in relation to Wales, in regulation 15(1) of the Central Rating List (Wales) Regulations 2005 (SI 2005/422);

“**Applicable Water Business Rate Costs_t**” means, to the extent that they could not have been avoided by prudent management action, the amount(s) payable in respect of Water Business Rates (such amount(s) payable being a function of rateable value multiplied by uniform business rate (UBR) (rate in the pound) less transitional relief) in Charging Year t minus any contributions towards Water Business Rates received, or likely to be received, by the Appointed Business in that year;

“**Menu Choice**” means the Appointee’s menu choice on the menu set out in Table A3.7 of ‘Final price control determination notice: policy chapter A3 – wholesale water and wastewater costs and revenues’. All references to the menu for the purposes of this Notified Item refer to that table;

“**Menu Choice Expenditure Factor**” means the allowed expenditure under the Appointee’s Menu Choice divided by what would have been the allowed expenditure if the Appointee’s Menu Choice had been 100;

“**Menu Cost Sharing Rate**” means the cost sharing rate set out in the menu that follows from the Appointee’s Menu Choice;

“**Water Business Rate Sharing Rate**” = 75%;

“**prudent management action**” shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time; and

“**Water Business Rate Cost Allowance_t**” means the figure for the relevant Charging Year set out in Table 7 (the “**Water Business Rate Constant_t**”) multiplied by the Inflation Factor and for these purposes:

- “**Inflation Factor**” = RPI_{t-1} / RPI_{2013} ;
- “**RPI_{t-1}**” means the Retail Prices Index published, or likely to be published, for November in Charging Year t-1; and
- “**RPI₂₀₁₃**” means the Retail Prices Index for November 2013.

Table 7 Water Business Rate Constant

Charging Year beginning 1 April	£million
2017	14.307
2018	14.307
2019	14.307

Land sales

For the purposes of the Determination Ofwat gives notice that for each of the five consecutive Charging Years starting on or after 1 April 2015:

- the value attributable to Relevant Disposals of Land allowed for in making this determination is zero; and
- variations in value received or expected to be received from Relevant Disposals of Land shall constitute a Relevant Change of Circumstance.