

Proposal by the Water Services Regulation Authority (Ofwat) to vary the appointments of Severn Trent Water Limited (“Severn Trent Water”) and Dee Valley Water Limited (“Dee Valley Water”) as a water and wastewater services company and water only company respectively.

About this document

Water Industry Act 1991 Section 8(3)

This notice is a consultation on our proposal to:

- (a) vary the areas to which the Instruments of Appointment (licences) of Severn Trent Water and Dee Valley Water relate.
- (b) grant a new wastewater appointment to Dee Valley Water.

Responses should be received by **10 January 2018**. Having considered any representations submitted in response to the consultation, Ofwat will decide whether or not to make the variations to these companies' appointments.

There are separate applications from each company in relation to the proposed new appointment and variations but as they are closely interlinked we are consulting on both of these in this document. References in this document to the "applications" are to the applications from Severn Trent Water and Dee Valley Water collectively and references to an "application" is either one of the applications, as the context requires.

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1. Responding to this consultation

We would welcome any comments on this document.

Please email them to FinanceAndGovernance@ofwat.gsi.gov.uk or post them to:

Severn Trent Water and Dee Valley Water NAV Application Consultation Response

Ofwat

Centre City Tower

7 Hill Street

Birmingham

B5 4UA

The closing date for this consultation is 10 January 2018. We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your responses to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004. If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

2. Background

Severn Trent Water currently serves around 4.3 million households and businesses in its area which covers an area from the Bristol Channel in the south to the Humber in the north, and from mid-Wales in the west across to the East Midlands. The vast majority of Severn Trent Water's customers are located in England but some customers are located in Wales.

Dee Valley Water was originally formed in 1997 from the merger of the former Chester Water Company and Wrexham Water Company. Dee Valley Water supplies water only services to approximately 258,000 customers across Chester and North East Wales and North West England. The majority of Dee Valley Water's customers are in Wales.

Severn Trent Water acquired Dee Valley Group plc, the ultimate holding company of Dee Valley Water, on 15 February 2017. Although they are still separate companies operating under separate licences, both Severn Trent Water and Dee Valley Water are part of the Severn Trent Plc group.

2.1 The sites

Severn Trent Water has applied to vary its area of appointment in order to be the water supplier for Dee Valley Water customers located in England - this includes 49,700 households and 4,000 businesses, charities and public sector organisations ("business customers") covering Chester and the surrounding areas including some in Cheshire, Shropshire and the Wirral ("The Chester Site"). The Chester Site is currently served by Dee Valley Water for water supplies only; wastewater services in the Chester Site are provided by United Utilities Water and will not be affected by this application.

If Severn Trent Water's application is successful, business customers in the Chester Site area will have their services provided by Water Plus¹, acting as Severn Trent

¹ In response to the business competitive market opening on 1 April 2017, Severn Trent and United Utilities Water created a new joint venture water retail company called Water Plus. Water Plus only serves business customers. Business retail services provided by Severn Trent migrated to Water Plus on 1 April 2017.

Water's agent. Severn Trent Water has indicated that, subject to the approval of the Secretary of State, it intends to exit the rest of the English business retail market in 2018 and transfer the rest of its business customers to Water Plus at the same time.

Dee Valley Water has applied to vary its water supply area of appointment and to be appointed as a wastewater services supplier to the Powys site (in addition to its current existing Welsh customers) and would start providing water and wastewater services for Severn Trent Water customers located in Wales. This will include 35,100 households and 3,900 businesses in the Powys area and parts of Monmouthshire ("The Powys Site"). Dee Valley Water would also start providing Severn Trent Water's wastewater customers in Wales with wastewater services – for customers in the Powys Site area only. Other wastewater customers in the rest of Dee Valley Water's area would continue to be served by either United Utilities Water or Dŵr Cymru/Welsh Water as they are currently.

Maps showing the Chester Site and the Powys Site are in appendix 1.

2.2 The applications

NAV applications can be made under one of three separate criteria:

1. **The unserved criterion** – most applications under this criterion have been for undeveloped (greenfield) sites but some have been for sites that are undergoing redevelopment (brownfield). The area needs to be currently unserved by an existing water company.
2. **The large user criterion** – company may apply for a new appointment to serve a customer who uses (or is likely to use) at least 50 million litres of water a year (in England) or 250 million litres of water a year (in Wales) at each of its premises and wants to change its supplier. The customer concerned must consent to the appointment.
3. **The consent criterion** – this applies when an existing appointee consents to transfer a specific part of its supply area to another appointee. The other appointee could be a new or existing appointee whose existing area of appointment could be varied to include this additional area.

Both the companies' applications in this case meet the **consent criterion**. The existing local monopoly suppliers for both the Chester Site and the Powys Site agree to transfer the site or premises to another company. We have seen letters from Dee Valley Water and Severn Trent Water confirming this consent as part of these applications.

2.3 The proposal

We propose to:

- vary the appointment of Severn Trent Water by adding the Chester Site to its water supply area;
- vary the appointment of Dee Valley Water by excluding the Chester Site from its water supply area;
- grant Dee Valley Water a new appointment in respect of wastewater services to the Powys site in order for it to become a water and wastewater company;
- vary the appointment of Dee Valley Water by adding the Powys Site to its water supply area; and
- vary the appointment of Severn Trent Water by excluding the Powys Site from its water supply and wastewater services areas.

By means of these variations, Dee Valley Water will become a Water and Wastewater Services company based wholly in Wales and Severn Trent Water will become a Water and Wastewater Services company based wholly in England.

3. Our policy for assessing new appointments and variations

When considering applications for new appointments and variations, we operate within the statutory framework - including our statutory duty to protect consumers, wherever appropriate by promoting effective competition. The legal framework for new appointments is set out in the Water Industry Act 1991 (WIA91)².

To support our assessment of NAV applications within this statutory framework and to provide transparency to applicants on our approach, we have published statements of our policy and process³.

Most NAV applications that we consider involve a new appointee becoming embedded in an incumbent appointee's area of appointment in respect of a new development or a single large user. Most of these new appointees do not undergo a full price review and their charges are linked to the charges of the incumbent who is subject to a price review. Other conditions in their instruments of appointment may also be suspended. The applications considered in this consultation involve two existing appointees which are subject to full price determinations and have a full suite of licence conditions which affect the service provided to and price paid by thousands of existing customers in their areas.

We have previously considered NAV applications in the context of mergers which affect large numbers of customers such as when South West Water and Bournemouth Water merged their areas of appointment. However, in those cases the parties sought to have a single enlarged area of appointment subject to the conditions of appointment (including a single price determination) of a single appointee. While the applications considered in this consultation concern two appointees following a merger, the appointees each seek to retain separate instruments of appointment with separate price determinations but in respect of varied areas of appointment. This has required us to consider how the application of

² Section 7 of the WIA91 sets out the criteria by which an appointment or variation may be made. Section 8 sets out the procedure for making that appointment or variation.

³ Our statement of policy for assessing NAV applications is available here: <https://064f1d25f5a6fb0868ac-0df48efcb31bcf2ed0366d316cab9ab8.ssl.cf3.rackcdn.com/wp-content/uploads/2017/09/Statement-of-NAV-policy.pdf>, our statement of process for assessing NAV applications is available here: <https://www.ofwat.gov.uk/publication/new-appointment-variation-applications-statement-process/> and our statement of approach to assessing financial viability for NAV applications is available here: https://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_pos20121112navfinance.pdf

price determinations affects relevant customers and, where appropriate, consider re-allocating key aspects of the price determinations to minimise customer impacts.

The unusual circumstances associated with the applications set out above mean that our assessment against our policy principles has been complex. In this consultation we have set out how we have applied each of our principles, why this approach is appropriate in this context and our conclusion in relation to each principle when it is applied to the applications concerned.

When assessing applications for new appointments and variations we consider 5 principles:

Principle 1: New appointees should be regarded as wholesale customers of and competitors to existing appointees. We consider this principle on page 7;

Principle 2: We will consider applications on a site-by-site and company wide basis as appropriate. We consider this principle on page 8 below;

Principle 3: Customers, or future customers, should be no worse off than if the site had continued to be supplied by the existing company. We consider this principle in pages 10-26 below;

Principle 4: Ofwat must be satisfied that an applicant is financially viable and will be able to finance the proper carrying out of its functions as a water and/or wastewater services company. We consider this principle in pages 26-28 below; and

Principle 5: Ofwat must be satisfied that an applicant is operationally viable and can demonstrate the competencies required to technically and operationally be able to fulfil the functions of an appointed water and/or wastewater services company. We consider this principle in pages 28-31 below.

3.1 *Principle 1 – the competitor principle*

When we consider NAV applications, we often consider the new appointee as providing competition to the incumbent appointee in relation to a new customer or group of customers. In this case, as we are considering the realignment of the boundary between two incumbent appointees, this principle is not applicable in the same way. However, in respect of the bulk supplies that will be required across the boundary between the two appointees, our [bulk supply principles](#) will apply which will support the application of the competitor principle.

3.2 Principle 2 – Considering applications on a site by site and company wide basis

We have followed our second principle, as we are considering the applications on a site-by-site and company wide basis as appropriate. As set out in relation to the three remaining principles, we have noted areas where we have considered a company wide assessment (for example in relation to financial viability) and areas where we have considered the impact on the Powys and Chester sites (for example in relation to service levels and the allocation of price determinations).

3.3 Principle 3: Customers, or future customers, should be no worse off than if the site had continued to be supplied by the existing company

Our statement of policy sets out that we will consider both price and service when considering the impact on customers. Companies making NAV applications usually provide evidence of their proposal by linking their proposed price and service to that of the incumbent appointee - who usually already has protections on price and service for customers set out in its licence, including through price review determinations.

In this case, Severn Trent Water and Dee Valley Water are already subject to their current licence conditions, including the current price review determinations. This means that our assessment is complex and takes into account the nature of these two companies, rather than a simple assessment against an incumbent's price and service levels.

Our statement of process states that companies should submit evidence relating to a comparison against the incumbent's codes of practice, minimum service standards, service and outcome incentives and performance commitments. We summarise our analysis below.

In line with our statement of policy, we have considered the overall effect on customers of granting the applications compared to no changes taking place. We considered not only the customers on the sites who will see their company change - in this case customers in the Chester Site or the Powys Site - but also the customers who will remain with the same company, for example current customers of Severn Trent Water based in England and current customers of Dee Valley Water based in Wales.

Our assessment against this principle is summarised below, with more detailed assessment set out under the headings in the rest of this section.

3.3.1 Service

- We have considered the applicants' comparison of the terms of their respective codes of practice (for domestic customers, debt and leakage) and the applicants' proposals for how to mitigate the impact of these changes (see page 11 below);
- We have considered the applicants' proposed service levels including the minimum service standards set out in the. Guaranteed Standards Scheme (GSS) and the proposed allocation of customer service levels set out in their respective Service Incentive Mechanism (SIM) (see page 12 below); and
- We have considered the applicants' proposals in relation to the allocation of their Performance commitments and Outcome Delivery Incentives (ODIs) (see page 14 below).

3.3.2 Price

- We have considered the applicants' charges schemes and Severn Trent Water's and Dee Valley Water's proposals in relation to the level of charges to be applied to affected customers (see page 17 below).
- Future prices depend on many factors, including business plans and price reviews that will apply after 2020. The companies have made assumptions in modelling prices, but it is likely that these will vary significantly from forecasts made today.

3.3.3 Other relevant factors

- A further impact of the applications is that the applicable legislation for customers in the Powys site will change from English legislation, as it is currently, to Welsh legislation and the applicable legislation for customers at the Chester site will change from the current Welsh legislation to English legislation⁴. This change is

⁴ The reason for this is set out in section [(e)] below.

expected to happen in any case when relevant provisions the Wales Act 2017 are fully commenced, but approval of the applications would bring forward this change for affected customers. We have considered the impact of this within this section, including where English and Welsh legislation currently differs and how the companies have proposed managing this.

3.4 Service

a) *Codes of practice for domestic customers, debt and leakage*

Severn Trent Water's codes of practice on customer service, debt and leakage would apply to the Chester Site, and Dee Valley Water's codes of practice on customer service, debt and leakage would apply to the Powys Site immediately after the licence changes take effect.

Following their applications, Severn Trent Water and Dee Valley Water have said that overall, customers will be no worse off and will receive (as far as possible) the same or better level of service. In Appendix 2, there is a table showing a side-by-side comparison between Severn Trent Water and Dee Valley Water's current codes of practice, and Severn Trent Water's and Dee Valley Water's proposals to address these differences. In most cases, this is a commitment to match the highest level of service across the two companies.

The main areas of difference between the two codes of practice are:

- Longer contact hours and more communication channels are available for Severn Trent Water customers than for Dee Valley Water customers. Dee Valley Water has agreed to offer these benefits to all of its customers, not just those in the Powys area;
- Severn Trent Water offers a Charitable Trust Fund for its customers in debt, and this will be extended to customers in Chester. Dee Valley Water will continue to offer a Charitable Trust Fund to customers in the Powys area, and will consider how this can be extended across the remainder of the Dee Valley Water area. Dee Valley Water has committed to working with its customers and stakeholders in Wales to better understand the affordability challenges and develop more effective measures to help vulnerable customers and those struggling to pay as part of its PR19 plans;
- Dee Valley Water has higher GSS (Guaranteed Service Standards) payments than Severn Trent Water. Severn Trent Water has committed to adopting the higher level of payments for customers in the Chester site;
- Dee Valley Water currently offers free service pipe repairs for its customers. Severn Trent Water stopped offering this in 2015. Dee Valley Water intends to stop offering this service whether its application is approved or not. However, Dee Valley Water has confirmed that if private supply pipes are adopted as a result of Welsh or UK Government legislation, it would support this.

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We welcome the commitments from Severn Trent Water and Dee Valley Water that they will match the highest level of current customer service levels of either company, based on the current customer codes of practice. Severn Trent Water and Dee Valley Water have stated that they will implement these benefits for all customers in both regions, and Severn Trent Water and Dee Valley Water have both committed to making these changes from 1st April 2018, allowing them time to engage with their stakeholders, including CCWater - subject to these applications being approved.

After 2020, both companies are likely to review their codes as part of their usual process and send us any revised codes of practice. We expect companies to consult with CCWater regarding any significant changes to their codes of practice. As Ofwat must approve changes to codes of practice, if we had any concerns about risks to customers caused by a company's failure to comply with their obligations, we could require Severn Trent Water and/or Dee Valley Water to review their approach and make changes if required.

b) Levels of service including minimum service standards (GSS), customer service levels (SIM) and voluntary standards

When we review NAV applications, we normally consider the service standards which a new appointee is proposing compared to the incumbent appointee. As these applications concern two existing water companies which must already meet standards on levels of service, this comparison is more complex.

Firstly, both water companies are currently required to comply with a set of minimum service standards for water services known as the Guaranteed Standards Scheme, or GSS. If we granted Dee Valley Water a wastewater appointment, it would also have to comply with the GSS for wastewater services. As the GSS regulations for appointees are the same in England and Wales, there will be no change in these for customers affected as a result of the applications.

Severn Trent Water and Dee Valley Water have committed to ensuring that customers will continue to be served by the same customer service teams. This means that customers in the Chester Site area will continue to be served by the same customer service teams, based in the same location as they are now. These teams will be recharged by Dee Valley Water to Severn Trent Water. As set out above, these customers will also benefit from an increased out of hours service and greater communications channels.

Customers in the Powys Site area will continue to be served by the current Severn Trent Water customer service teams and these teams will be recharged to Dee Valley Water.

Secondly, both companies are subject to the Service Incentive Mechanism (SIM). The SIM is an annual incentive included in price determinations which is designed to encourage water companies in England and Wales to provide better customer service. The SIM provides incentives to the best performing companies for good customer service and penalises the worst performing at the end of the price control period.

For Severn Trent Water, the SIM only applies to households and not businesses, with any high performance payment or poor performance penalty applied to revenue at the end of the price control period. For Dee Valley Water, a separate SIM applies to both household and business customers – but the SIM for business customers is separate to the SIM for household customers, and does not have financial incentives attached to it.

The customers of Severn Trent Water and Dee Valley Water would change as a result of the applications, as Severn Trent Water would no longer serve customers in the Powys site but would take on customers in the Chester site. Dee Valley Water would no longer serve customers at the Chester site, but would take on customers at the Powys site.

As the applications are proposing to vary Severn Trent Water and Dee Valley Water's licences three years into a five year price control period we consider that, in order for customers to be considered to be "no worse off", any poor performance penalties and high performance payments for the first three years should follow the customers.

- We propose to do this by splitting customers into households and business customers into four groups: Severn Trent English customers excluding the Chester Site; Dee Valley Water Welsh customers excluding the Powys Site; the Chester Site; and the Powys Site.

For each group of customers, we will calculate the applicable poor performance penalty or high performance payment proportion due to them under the first three years of the control period and last two years of the control period.

We will then be able to determine what adjustments need to be made to the new companies' controls at PR19. This will make sure the correct low performance penalty or high performance reward is attributed to the right customers and the right company both before, and after, any variation to Severn Trent Water or Dee Valley Water's licences.

This is illustrated in the following example:

If Severn Trent Water's SIM score resulted in a 0.1% poor performance penalty for Severn Trent Water, and Dee Valley Water's SIM for household customers resulted in a 0.1% high performance payment, the new Dee Valley Water Welsh company's household retail control would receive:

- A poor performance penalty of 0.1% on household revenue of c£6.3m from former Severn Trent Water customers in the Powys site.
- A high performance payment of 0.1% on household revenue of c£9.6m from former Dee Valley Water customers in the Chester site.

• Under the SIM, payments relate to performance in four years: 2015-16 to 2018-19. The companies would need to ensure that any poor performance penalty or high performance payments were split appropriately so that the customers who experienced the poor or high performance received the SIM underperformance penalty or paid the SIM high performance payment respectively. If the companies changed from 1 April 2018, then three-quarters of the SIM payments would be attributed to the predecessor companies and their customers. Only one quarter of the SIM payments would be attributed to the customer base of the new companies.

Dee Valley Water also has a business customer SIM because its existing customer base are largely not eligible for the competitive business retail market unless they use over 50MI/annum. But as there are no financial incentives attached to the business customer SIM, the issue of splitting any SIM financial payments between the companies does not arise.

c) Performance commitments and ODIs

All large companies, including Severn Trent Water and Dee Valley Water, have performance commitments and outcome delivery incentives (ODIs) as part of their price review – and they must report on their progress against these performance commitments each year. For many performance commitments, there is also a financial incentive as well as this reputational incentive. Some of these financial ODIs are 'in-period', with annual adjustments for outperformance or underperformance. The rest are 'end-period', with adjustments made at PR19.

When considering if customers would be no worse off under these applications, we have considered Severn Trent Water's and Dee Valley Water's approach to their performance commitments and ODIs for the first three years and the remaining two years of this AMP period. If the applications were approved, both companies would propose new performance commitments and ODIs from April 2020 onwards as part

of the PR19 process in respect of their new areas. But commitments made to customers as part of the 2014 price review would still apply in 2018-19 and 2019-20, even though the companies will have changed.

Severn Trent Water currently has 45 performance commitments of which 33 have a financial incentive; Dee Valley Water has 13, of which nine have a financial incentive. Dee Valley Water does not currently have any wastewater ODIs but if it became a wastewater provider, it would take on Severn Trent Water's wastewater ODIs for the Powys region for the remaining two years of this AMP period. It would then propose new performance commitments and ODIs for wastewater at the next price review.

For Severn Trent Water, only one of the performance commitments is within the retail business unit, the Service Incentive Mechanism (SIM) which we discuss above.

As customers in the Chester Site area are currently only receiving water services from Dee Valley Water (United Utilities Water provides the wastewater services in these areas) and will continue to receive only water services from Severn Trent Water, there is no impact on wastewater ODIs for customers in the Chester Site area as a result of this application.

For wastewater customers in the Powys area, the existing Severn Trent Water performance commitments and ODIs will need to be split so that customers at the Powys Site are in the same position if Dee Valley Water supplies them.

For water ODIs it is more complex - though since Severn Trent Water and Dee Valley Water are currently both average performers on wholesale water price control performance commitments, ODI outperformance and underperformance adjustments are likely to be small. We have split these into before, and after, the proposed boundary changes.

The three years before the boundary change:

Severn Trent Water and Dee Valley Water have stated that they will apply the principle that customers should – as far as possible – pay no more or less for the regulatory incentives than they would have done if there had been no change in the boundary.

As such, they have proposed calculating the outperformance payments and underperformance penalties for the first three years for the existing areas of appointment, and then apportion this between the two companies based on:

- For ODIs that lead to revenue adjustments, a split between the regions based on relative wholesale revenues;

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- For ODIs that lead to RCV adjustments, a split between the regions based on relative RCV;
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- For in-period ODIs where changes to revenue are being made from 2018 onwards for performance in the early years of the price control, ODIs will be allocated in line with wholesale revenue. This would require Dee Valley Water's licence to be amended to permit in-period adjustments (see Appendix 4). Although this would result in an adjustment to K for the Welsh company, Dee Valley has said that Wrexham customers will not bear the impact of Severn Trent (Powys) ODI payments during 2015-20, and our determinations of in-period ODIs will reflect this.

This approach is a pragmatic way of ensuring the ODI payments to and from customers reflect the performance they received and the performance commitments agreed at PR14.

We note that Severn Trent Water, in its 2017 in-period ODI application, has proposed to smooth its bills and hence to delay some outperformance payments to later years of the price control period or to PR19. The approach above should apply to all ODI outperformance payments or underperformance penalties, regardless of whether they were delayed or not.

The two years after the boundary change:

Severn Trent Water and Dee Valley Water have proposed that they will split the performance commitment levels to develop new performance commitment levels for each area. They will also split reported performance to reflect the boundary between England and Wales, and then for any financial ODIs will calculate outperformance payments and underperformance penalties in line with the new performance commitments. Appendix 3 contains tables of the current ODIs for Severn Trent Water and Dee Valley Water with the proposed split for performance commitment levels and for performance reporting after the proposed licence amendments to reflect the new licences.

The companies categorise the proposed changes they would make to performance commitment levels in three ways, which are reflected in appendix 3:

- **Specific levels for specific activities.** For example, catchment management schemes which target specific areas – in these cases the commitment level would be split based on the area in which the current activity is to be carried out.
- **No change in levels.** That is, both companies are currently subject to the same commitment levels and should continue to be so. For example Mean Zonal

Compliance should be 100% in both the Welsh and English areas, in line with the current 100% compliance commitment level overall.

- **Allocation of level.** The commitment level could be split based on some information about assets or processes - such as 'km of pipe' or 'volume of water delivered'. Or alternatively, some other measure such as risk (such as sewer flooding commitment levels based on the number of properties at high risk in each area). In other examples, it will be appropriate to adjust based on current performance to capture the regional nature of the commitments.

For performance reporting, the companies have proposed the following approach, also reflected in the table in appendix 3:

- Where ODIs are based on the service delivered to a customer, they propose to report performance based on the **appointee delivering the service**. This includes all retail incentives, but also some wholesale ones;
- Performance on some **asset-based measures** can be allocated based on the location of the asset (using National Grid Reference of the asset), or the specific asset which benefits; and
- Leakage and some other measures for the water service are more complex, because areas such as the Water Resource Zone, Quality Zones or District Metering Areas can in some instances span the national border. Where this occurs, the companies have considered a sub-split based on either the number of properties; or the amount of water supplied on each side of the border. The latter would rely on readings from customer meters or estimates of unmetered consumption to inform an appropriate allocation.

If Severn Trent Water was due to receive an outperformance payment for providing improved services to its customers (under their outcome performance commitments at PR14), this would increase bills for customers in its English operating area and the Powys Site.

We agree with the companies' proposal to take a different approach to the revised areas for the final two years of the price control period than in the first three years. From 1 April 2018, it is appropriate to calculate performance commitments and ODIs for the revised areas – as long as the companies can maintain the original commitments to customers made by both companies. This will make it easier for the companies to transition to their new performance commitments to customers for 2020-25, on which the companies are already engaging with their customers. It is important that from 2020-21 onwards the companies propose stretching performance commitments which reflect extensive customer engagement and challenge from their Customer Challenge Groups.

The companies are proposing to use appropriate drivers to split commitment levels and to split their reported performance. For example, for performance commitment WA1, “Number of complaints about drinking water quality”, the performance commitment level is split between the two regions based on the proportion of total customers in each region and performance is split between the companies based on the postcode of the customer who has complained.

Severn Trent Water and Dee Valley Water have both committed to continue to uphold their outcome commitments set at PR14 in the relevant areas for the rest of the period, transferring these (or parts of these) along with customers where this is applicable. We will publish the new outcome commitments alongside any final decision on the applications, if applicable, and we will expect each company to report against these commitments in 2018-19 and 2019-20, as well as in any information provided as part of the business plans.

3.5 Price

a) Charges scheme - statements of assurance

Under the Water Industry Act, companies must publish charges schemes to apply charges in their area – and under our charging rules, they must also publish statements of assurance that they have followed the relevant charging rules and obligations. Both Severn Trent Water and Dee Valley Water currently have published charges schemes and statements of assurance covering their current areas. Following any licence changes, if we approve the applications, we would require both companies to produce new charges schemes covering their revised areas and new statements of assurance for those charges schemes.

b) Customer charges

Companies making NAV applications are not usually subject to a Price Review process but are instead required under their licence to link their prices to the incumbent in whose area the customers are located. However, as these applications are being made by two incumbent companies which are subject to price reviews, the charges their customers pay must comply with their price limits. We have therefore considered the effects on customer charges in more detail as part of these applications than a usual NAV application, as it is significantly more complex. Unlike other NAV applications, charges will also be subject to future price reviews.

For 2017/18 – 2019/20

Both Severn Trent Water and Dee Valley Water have published charges for 2017/18, and these will continue to apply to the original areas of appointment because the licence changes are not proposed to take effect until 1 April 2018.

For 2018-19 and 2019-20, Severn Trent Water propose to charge customers who have moved from Dee Valley Water to Severn Trent Water (that is, customers in the Chester Site area) a bill determined on the same basis as ongoing Dee Valley Water charges – that is, based on our Final Determination for Dee Valley Water at PR14.

Bills for Chester and the surrounding area have never been merged with those of Wrexham, and remain set at a different level.

All types of charge, whether measured, unmeasured or fixed, will be the same as those that would have applied if no changes were made to boundaries. This includes the small number of Wrexham customers that fall into England, who will continue to be charged at a different rate from the rest of Severn Trent Water.

Severn Trent Water and Dee Valley Water have confirmed that customers in the Chester Site and Powys Site areas will not see an impact on their bills as a result of these applications until at least 2020.

For 2020/21 and beyond

We have considered the impact of these applications on customer bills beyond 2020.

Future prices depend on many factors, including business plans and price reviews that will apply after 2020. The companies have made assumptions in modelling prices, but it is likely that these will vary significantly from forecasts made today.

Nevertheless, the companies have modelled bills beyond 2020 by assuming that current costs and price controls will continue to apply after 2020, as we wanted to understand the impact of these applications on bills in the long-term.

When considering whether or not customers will be worse off as a result of these applications, we have set out below where some of the impacts of the applications would have upward or downward pressure on bills. There will be other impacts on bills from future business plans and price reviews, which will be unrelated to these applications. We have also not included in our modelling, for example, the effects of any future decisions by the relevant companies to change their tariffs in response to higher levels of metering – where we might expect to see higher bills in the Powys region in future.

Within all company areas across England and Wales, there are currently cross subsidies between rural and urban customers. Urban customers typically cost less to serve - for example, many urban properties may be located on a single stretch of water main or closer to a water treatment works than rural customers where fewer properties might be spread over a much larger geographical area. These cross subsidies are allowed under water company licences, as they are not 'undue discrimination or undue preference' (under Condition E).

The Powys Site is a very rural area and currently customers in this region receive some cross subsidy from other Severn Trent Water customers based in England. Although this is a negligible proportion of a Severn Trent Water English customer's bill as it is spread over a large number of customers, it saves each customer based in the Powys Site around £15 each per year on average. The cross subsidy is particularly significant for the wastewater service.

If this application was successful, in order to prevent a sharp increase in bills for customers in the Powys region in the first year, Severn Trent Water and Dee Valley Water propose to preserve the benefit of the current cross subsidy that Powys customers currently receive from 2018 – 2020 and for a period of time afterwards. To understand how they propose to do this once the Powys customers do not fall within the Severn Trent area, it is first necessary to understand how bills cover the costs of the service customers receive.

As part of the work for the first price review in 1994, all companies' were given a Regulatory Capital Value or RCV. This was an estimate of the market value of the company's assets at the time of privatisation.

Customers' bills pay for both the day-to-day running costs (operating expenditure or opex) and also the construction costs of assets (capital expenditure or capex) over the lifetime of assets such as reservoirs, sewerage treatment centres, and so on. A company usually raises the money for building these assets through loans or funds from shareholder investments and then pays them off over time. This is similar to how people pay for the day to day running costs of a house such as electricity and maintenance (opex) as they occur but the value of the house (capex) is usually paid off over the longer term with a loan or mortgage to a bank.

We reflect this in price controls by adding the capex to the company Regulatory Capital Value (RCV). Customer bills must cover the company's running costs (opex) as well as repayments to shareholders or banks for any assets the company has borrowed money to build (capex).

Customers in the Powys site area have higher running costs to provide them with water and wastewater services compared to Severn Trent customers on average as they are in a very rural location. Each customer needs a greater extent of assets to

serve them – for example, this could mean longer lengths of pipe when compared to the average for Severn Trent Water customers.

In addition to this, customers in this area tend to have lower than average bills within the Severn Trent region. The majority of customers pay an unmetered bill that is determined according to the rateable value of properties that was a value decided for taxation purposes between 1973 and 1990. These rateable values tend to be lower in Powys than average in the Severn Trent area, and so the bills are lower too. This increases the average cross subsidy for customers in the Powys area from customers in the rest of Severn Trent Water's area. This means that when Powys customers are no longer part of Severn Trent Water they would see bill increases, as bills will begin to better reflect the costs involved in serving these customers without any cross subsidy from the rest of Severn Trent's customers. Without any mitigation this increase would be around 2.7% on a wastewater only bill. We do not believe this increase would be appropriate.

In order to reduce this bill impact, Severn Trent Water proposes an RCV at the lower end of a reasonable range to its Welsh customers when it transfers the wastewater assets to Dee Valley Water. Since the running costs (opex) in the Powys Area are higher than the average across Severn Trent Water, this would help to keep the bills in the Powys Area from increasing in the short term by reducing the amount of repayment and financing costs (capex) for the assets they are using.

In the longer term, as there is new expenditure and maintenance of assets in the Powys Site area as part of normal business, the benefit of this initial RCV allocation will be eroded because new expenditure in Powys will be added to Dee Valley Water's RCV at the full cost. In the long term this will unwind the effect of the lower allocation of RCV to Welsh customers. It also means that bills for Severn Trent Water customers in England in the long term are likely to be slightly lower than they may otherwise have been if these applications for licence changes were not made.

However, in addition to this greater expenditure for the new Dee Valley Water Welsh company due to them taking on customers in the Powys site, there would also be some additional income from the Powys site. There are two reservoirs in the Powys region that currently do not serve any customers but provide an income to Severn Trent Water through long term contracts with the EA and another water company to provide them with extra resilience. As a result of these applications these reservoirs would move from Severn Trent Water to the new Dee Valley Water Welsh company, and therefore so would the income. This additional income would reduce water bills for customers of Dee Valley Water from 2020-21 (that is, after the current price controls have expired).

These two impacts – reductions from the reservoir income and rises from the RCV expenditure – would interact. The company forecasts that bills would drop from

2020-21, and reach the level in 2019-20 again by about 2026-27, and then there would continue to be upward pressure until 2034-35 and beyond. The overall effect on water-only and combined water and wastewater customers' bill from 2020 – 2035 as a result of this application would be neutral. These estimates are subject to the impact of price reviews, and both companies have said that they expect bills to fall at the next price review (PR19) due to a lower cost of capital and the impact of efficiency savings that they will deliver.

Since the reservoir income would apply just to water bills, Dee Valley Water is concerned about the rate of increase in wastewater-only bills over time. The company has proposed using some of reduction in water bills to offset the increases in the wastewater bills in its area. The water bills will still go down initially, but not by quite as much. Instead, wastewater bills will rise by a smaller amount – Dee Valley Water estimates that this would be limited to around 0.8% per annum in real terms (approximately 80p/year for a wastewater only customer in Powys).

Severn Trent Water has told us that the border changes do not in themselves trigger immediate incidence effects. There were issues with Dee Valley Water's previous application of the tariff differential which could create some incidence effects for unmetered customers. Severn Trent has discussed these with CCWater and has confirmed that they will resolve them over time.

Our view of these proposals

The eventual gradual unwinding of the current cross subsidy across different company areas, while managing the level of increase in any one year, is consistent with the approach set out in our charging rules.

We consider that overall when we consider the period 2018-2035, there is minimal effect on customers as a result of these applications.

For 2018-19 and 2019-20, there will be no change in bills for customers in the Powys or Chester sites compared to their bills if this proposed change in boundaries did not take place.

From 2020, there will be some minor impacts from this change on Severn Trent Water customers' bills. Severn Trent Water will no longer benefit from the income from reservoirs in Powys, and will have a slightly higher average RCV per customer. Since these impacts will be spread over so many customers, the individual bill impacts related to this will be extremely small. But there are also factors that will tend to put downward pressure on bills in the long term, because Severn Trent Water will no longer be providing a cross subsidy to customers in Powys (who have relatively high costs to serve but relatively low bills).

Although wastewater only customers in Powys may see their bills increase by an estimated 0.8% per annum from 2020 (in real terms), we estimate that by 2034-35 the bill impact for Powys customers as a result of this application will still be below the Severn Trent Water average. And the applications would likely reduce the likelihood of other upward pressures on bills – such as likely tariff increases over time due to increased metering in the Severn Trent area, which could lead to an increase in unmetered charges in the Powys region in the absence of any changes. We consider that, although there are some upward pressures on wastewater bills as a result of these applications, the applications may also result in existing upward pressures being avoided. And so on balance, the applications are not likely to create a detriment to customers.

3.6 Other relevant factors

a) Application of Welsh legislation and policy to Powys Site customers and English legislation and policy to Chester Site customers before the Wales Act

The applicable law in relation to customers' water and wastewater services is determined by where the area of the appointee that serves them is “wholly or mainly” based (that is, either in England or Wales). When relevant provisions of the Wales Act 2017 come into effect, customers will be subject to the law of the country in which they are based – that is, the law will be applied along the national border between England and Wales. As our approval of the applications could bring about this change sooner than customers may have anticipated, we have considered some areas where the position under English and Welsh legislation currently differs, how customers may be affected earlier than anticipated and the companies' proposals for managing this.

b) Ability to choose retail supplier for business customers

All business customers served by appointed companies whose areas are wholly or mainly in England (including Severn Trent) can choose their water and wastewater retailer. Customers of appointed companies whose areas are wholly or mainly in Wales (including Dee Valley Water) can only switch their water service retailer if they use more than 50MI per year.

If Dee Valley Water's application were granted, customers in the Chester site would move to Severn Trent Water – and so all business customers in this area would be able to switch their water and wastewater service retailer from when the licence

changes come into effect. Severn Trent Water proposes to notify all business customers in the Chester Site area if they become eligible to change supplier.

Severn Trent Water's business customers who are currently based in Wales and use less than 50MI per year have been able to switch their water service retailer since April 2017 when the new business retail market opened. Of all the businesses in the Powys Site area, 3,157 were able to switch supplier – but Severn Trent Water and Dee Valley Water have confirmed that no eligible customers in the Powys Site area have changed supplier since the market opened.

If the applications were successful, business customers using less than 50MI per year in the Powys Site would transfer to Dee Valley Water when the variations take effect and would no longer have the ability to choose their water and wastewater service retailer. If a business customer in the Powys Site area moved from Severn Trent Water to a different water service retailer before the variations took effect, they would be moved again to Dee Valley Water when the variations take effect.

This reflects the different government policies in England and Wales to which Ofwat has regard when carrying out its functions, and so we do not consider either change to leave customers any worse off as a consequence of moving under different legislation. We consider that customer views on their ability to switch suppliers are also relevant to our assessment, and both Severn Trent Water and CCWater conducted research with the affected customers.

Severn Trent Water has informed us that it wrote to all business customers located in the Powys Site in March 2017 to advise them of its plan to apply for their area variation and the implications for switching retail supplier. This may have contributed to no business customers having chosen to change water and wastewater service retailer in this area.

Severn Trent Water carried out some customer research exploring the impact of their proposed change of area on the ability of business customers to switch supplier. Most of the customers invited to the focus groups had a low level of awareness about the opening of the business retail market. None of them had looked into switching supplier; they were happy with the service they received at present and they considered it unlikely that they would change unless prompted to do so through direct marketing.

Severn Trent Water also commissioned three telephone interviews with larger organisations in the Powys Site area who were using more water. All of these organisations thought that there could be potential price benefits to competition, but stated that unless the savings were significant they would be unlikely to change supplier. Businesses in the Chester Site were in favour of the alignment, and could

see benefits of being able to choose their supplier, though those who took part in the survey indicated they would be unlikely to actively pursue it.

CCWater conducted its own customer research asking around 3-4,000 business customers in the Chester Site area and Powys Site area their views on these applications and the effect on switching. CCWater had a very limited response to their research with an insufficient number of replies to be able to draw any robust conclusions. This in itself may indicate limited customer concern in these areas.

We do not believe there will be any detriment to customers in terms of the different eligibility thresholds for retail competition as a result of this application. There was limited concern in either area about these changes.

Severn Trent Water and Dee Valley Water have committed to working with CCWater to ensure that communications about and support for these changes are adequate for business customers.

c) Limits on the right to make new connections to public sewers

Since 1 October 2012, there have been differences between English and Welsh legislation regarding the right of developers to make connections to a public sewer for companies wholly or mainly based in Wales (that is, Dee Valley Water and Dŵr Cymru/Welsh Water). This has implications for developments currently underway in the Powys Site where developers may think they need to comply with English legislation and will be able to connect to the public sewer after 1 April 2018, but who may need to check that the standards of their drains comply with Welsh Government Standards. In practice, this means that:

- A drain or sewer constructed after 1 October 2012 cannot be connected to a Dŵr Cymru/Welsh Water public sewer unless:
 - an adoption agreement has been entered into in relation to the drain or sewer; and
 - the adoption agreement provides for the drain or sewer to be constructed in accordance with the standards published by the Welsh Government unless the parties expressly agree otherwise;
- From the date of any licence change making Dee Valley Water the wastewater service provider for the Powys Site in Wales, the same restrictions would apply in relation to any drain or sewer constructed after 1 October 2012 that has not yet been connected to Severn Trent Water's current public sewers in Wales.

This does not yet apply to Severn Trent Water and other wastewater service providers whose areas are wholly or mainly in England.

Severn Trent Water and Dee Valley Water have stated that it is difficult to tell how many developers will be affected, but they note that it is a relatively small area with a small number of wastewater connections (about 250 per year). As such, many developers could have a one-off application that they will never repeat within the area.

Severn Trent Water has confirmed that it is looking at the direct communications it could use to raise the profile of this change when engaging with potential developers, but we acknowledge that developers who already operate elsewhere in Wales are likely to be aware of these regulations already.

Severn Trent Water and Dee Valley Water consider that the main difference between the positions under English and Welsh legislation in this regard is that developers will need to build the connection to Welsh standards but, as these are similar to SFA7⁵, the standards should be broadly the same as today. Severn Trent Water and Dee Valley Water have confirmed that their staff will need to be both aware of the changes and trained appropriately.

Severn Trent and Dee Valley have committed to working with CCWater to ensure any communications and support are adequate for developers.

As there are likely to be a relatively small number of developments affected, the standards are similar between England and Wales, and for those developers who are affected Severn Trent Water and Dee Valley Water have committed to providing support, we do not believe there will be any significant detriment to developers relating to this difference in English and Welsh legislation in either the Powys Site or the Chester Site as a result of these applications.

d) Obligations on residential landlords

Since 1 January there have been additional obligations on residential landlords based in the Dee Valley Water area and the Dŵr Cymru/Welsh Water area. In practice, this means that:

⁵ Sewers for Adoption 7th Edition

- Non-resident owners of rented residential premises are required to give information about the occupiers to water companies – or else become jointly liable for the bill with the occupiers – if their premises are supplied with water, or receive wastewater services from, Dŵr Cymru/Welsh Water or Dee Valley Water; and
- Non-resident landlords of residential premises in the Powys Site could therefore become jointly liable for their tenants' bills from the date of any licence changes as a result of this application if they did not provide information about the occupiers to Dee Valley Water.

These additional obligations do not apply to Severn Trent Water and other companies whose areas are wholly or mainly based in England.

According to Severn Trent Water's records, around 5,850 of the household properties it currently serves in Wales are occupied by tenants - but this does not indicate the number of non-resident owners, and many landlords will own multiple properties. It has not been necessary for Severn Trent Water to obtain details of the property owners in the Powys Site before now.

Although Dee Valley Water's position has been different, Dee Valley Water has also not maintained specific details of tenanted properties to date. Severn Trent Water and Dee Valley Water have committed to addressing this in the future.

But Dee Valley Water has made use of the Welsh Government Regulations to obtain more rapid notification of any change of occupier. The regulations have helped the company to ensure that its customer base is updated more quickly, allowing them to start billing the correct occupiers sooner.

Prior to February 2017, Dee Valley Water did not pursue debt directly from landlords. Severn Trent Water and Dee Valley Water are currently examining the operational impact of these changes to ensure the appropriate level of engagement with both stakeholders and affected customers, as well as considering operational changes following any licence changes if these applications are granted.

The impact of this difference in legislation on landlords should be minimal and require little expense as landlords in the Powys region would only be required to inform Dee Valley Water of their tenants' details in order to avoid joint and several liability. Dee Valley Water and Severn Trent Water have committed to carrying out appropriate engagement with affected customers and stakeholders and communicate any new landlord's responsibilities effectively to any affected customers. We do not believe there will be any significant detriment to customers relating to this difference in English and Welsh Legislation in either the Powys Site or the Chester Site as a result of these applications.

Severn Trent Water and Dee Valley Water have committed to working with CCWater to ensure these communications and support are adequate for residential landlords.

3.7 Principle 4: Ability of Severn Trent Water and Dee Valley Water to finance and properly carry out their functions

In this section we detail our findings relating to the effect of the application on Severn Trent Water's and Dee Valley Water's ability to finance and properly carry out their functions.

Although both companies are in the same Severn Trent Plc group, they must both be separately able to raise finance and have sufficient funds to operate as a standalone water and wastewater company. Our statement on our approach to assessing financial viability of applications for new appointments and variations clarifies that we will look at a company level of assessment of financial viability in most cases.

In order to assess this we have considered the:

- level of financing costs (including debt repayments and dividends);
- level of debt;
- estimated levels of profit and cash flows; and
- the level of income from household and business customers.

Both Severn Trent Water and Dee Valley Water are already able to finance their functions and raise capital under the current areas of appointment.

We have no concerns regarding Severn Trent Water being a financially viable company which will be able to finance its functions if the application is approved. The proposed changes relate to a relatively small proportion of Severn Trent Water's customers and any costs associated with the changes are also minimal compared to Severn Trent Water's overall revenue.

However, as Dee Valley Water is a significantly smaller company and will be taking on more customers as well as wastewater functions, this is an area we considered in more detail.

Both companies have modelled their financeability under these proposals, based on broad assumptions about future costs and financial markets. Neither company considers that there would be an issue with financeability at 'appointee' level – where, at price reviews, we would normally test, as part of satisfying our duty under the Water Industry Act 1991, that companies can finance their functions. Having

considered the companies' current modelling, we are satisfied that this conclusion is reasonable. We will expect both companies to revisit and update their models for PR19 once we have published our methodology in December 2017.

The number of customers in the Powys area is a small proportion of the total for Severn Trent Water. But it is a much larger proportion of Dee Valley Water, which has a much smaller wholesale control.

We would normally expect each of the water and wastewater controls to have some headroom against cash flow financial ratios in their own right, but the figures provided to us by Dee Valley Water for the wastewater control indicate that it would not individually be financeable – with the cash interest cover being lower than we would expect.

A low interest cover (below one) indicates that the control is not generating sufficient cash flows to enable a company to make its interest payments within this individual wholesale control. We would expect interest cover for the wastewater control for the new Dee Valley Water Welsh company to improve slowly.

This is because the company has proposed to limit annual increases in wastewater bills for Powys customers as a result of these applications using financial levers (PAYG and RCV run-off, see page 21 above).

If we were to expect a self-financing wastewater control in the new Dee Valley Water Welsh company (with an interest cover of 1 or higher), the company estimates that this would require a real increase of 2.7% in wastewater bills in the first year (before any other upward pressures on bills). Under Dee Valley's proposed approach, they estimate there would be an increase in wastewater bills in Powys by about 0.8% per year as a result of these applications.

For Dee Valley Water, the wastewater control would not be independently financeable under the proposed approach. If wastewater bills were increased to allow Dee Valley Water's water and wastewater controls to be separately financeable then it would mean higher bills for wastewater only customers. We do not believe it is in customers' interests for us to insist the wastewater control is independently financeable in this case.

Under this proposal, Dee Valley Water could use financial levers (PAYG and RCV run off) to manage the impact on wastewater customers' bills in the Powys region for a transition period, up to 2030.

In order to protect customers by ensuring that the company continues with these transitional arrangements, it is important for us to secure a commitment from Dee Valley Water that they accept that there will be a period over which their wastewater control set in future price reviews will not look financeable on a stand-alone basis.

Dee Valley Water have therefore stated that they accept that the wastewater control will not be financeable. They have also said they will not seek to use the financial levers (PAYG and RCV run-off) to address any waste financeability issues, provided the company remains financeable. We expect their business plan for PR19 to reflect this commitment.

3.8 Principle 5: Operational viability

In this section, we set out our findings relating to the effect of the applications on Severn Trent Water and Dee Valley Water's ability to demonstrate to us that they both have the competencies required to technically and operationally be able to fulfil the functions of an appointed water company.

As the first application is for Severn Trent Water - a longstanding existing water and wastewater services supplier - to add the Chester Site area to its current licence, we are satisfied that it has the competencies required to technically and operationally be able to fulfil the functions of an appointed water and wastewater company across all of its proposed new area.

For the same reason, we are also satisfied that Dee Valley Water has the competencies required to technically and operationally be able to provide water services in the Powys Site area and also to continue to provide these services to the rest of its customers based in Wales.

However, as Dee Valley Water is currently a water only supplier we have carefully considered whether it will be able to technically and operationally provide wastewater services to customers in Wales for customers currently supplied by Severn Trent Water.

3.8.1 a) Asset transfer

All relevant property, assets, rights and liabilities in Wales currently held by Severn Trent Water in Wales will be transferred from Severn Trent Water to Dee Valley Water using a Statutory Transfer Scheme. Severn Trent Water and Dee Valley Water's NAV application was supported by a draft transfer scheme and we will receive the final version for Ofwat's approval before the end of the consultation process.

The same will also apply to all relevant property, assets, rights and liabilities currently held in England by Dee Valley Water, which will be transferred from Dee Valley Water to Severn Trent Water through a Statutory Transfer Scheme.

Once the schemes have been approved by us and executed, Dee Valley Water and Severn Trent Water will be the legal owners of the assets they require to carry out their functions.

We have asked that, when the final Statutory Transfer Scheme is sent to Ofwat for approval, it is supported by assurance from Severn Trent Water's and Dee Valley

Water's boards that all assets which are required by each company to properly carry out their functions as water and wastewater companies have been transferred.

Dee Valley Water will initially outsource the operation and maintenance of the transferred assets in Wales through an arm's length agreement with Severn Trent Water. Severn Trent Water will also initially outsource the operation and maintenance of the transferred assets in England to Dee Valley Water which will also be through an arm's length agreement.

These arm's length agreements will be detailed in an operating manual which is currently being prepared by Severn Trent Water. The company has explained that an arm's length operational service agreement governing the terms of services provided to Dee Valley Water will also be put in place.

We have seen a draft of this operating manual and provided comments to the companies, but we will see the final version in December 2017 before this consultation period closes. It is proposed that the agreement will take effect from 1 April 2018. Severn Trent Water and Dee Valley Water will also provide assurance that the final version is fully compliant with respective licence conditions and Regulatory Accounting Guideline 5 (Guideline for transfer pricing in the water and sewerage sectors).

Given the role that the operating manual will play in ensuring that Dee Valley Water and Severn Trent Water are operationally viable following any changes to their areas of appointment, we will check the final document as part of our normal regulatory duties to ensure that it is in line with the commitments that the companies have made throughout the process of their applications. Severn Trent Water and Dee Valley Water have stated that the following will be in place:

- The new Severn Trent Water English company will have sufficient and robust arrangements in place to protect customers in the event of special administration for the company, and in the event of the company being sold and leaving the group.
- The new Severn Trent Water English company will have sufficient and robust arms-length agreements in place with the new Dee Valley Water Welsh company to enable the company to fulfil its functions. For example, where services essential to the running of the new Severn Trent Water English company are provided under an arms-length agreement with the new Dee Valley Water Welsh company, such as Dee Valley Water customer service operatives working in a Severn Trent Water call centre in Chester.
- The new Dee Valley Water Welsh company will have sufficient and robust arrangements in place to protect customers in the event of special

administration for the company, and in the event of the company being sold and leaving the group.

- The new Dee Valley Water Welsh company will have sufficient and robust arms-length agreements in place with the new Severn Trent Water English company to enable them to fulfil its functions. For example, where services essential to the running of the new Dee Valley Water Welsh company are provided under an arms-length agreement with Severn Trent Water such as Severn Trent Water wastewater operatives working on Dee Valley Water wastewater assets in Powys.

To ensure operational viability, we also expect the companies to accept the most recent version of the financial ring-fencing licence condition (Condition P). The companies have accepted this in principle.

3.8.2 b) Governance

Following the acquisition of Dee Valley Water by Severn Trent Water in February 2017, Severn Trent Water and Dee Valley Water are both separate companies within the Severn Trent Plc group.

If these applications is successful, Severn Trent Plc has informed us it intends to operate the two separate companies, Dee Valley Water and Severn Trent Water, on an integrated basis - for example, in eventually using a shared customer service department. Severn Trent Water believes that this will maximise the synergy potential and therefore increase benefits to customers. Both Severn Trent Water and Dee Valley Water would, however, retain different brand identities and if this application were successful Dee Valley Water would aim to establish a strong Welsh identity which may involve rebranding.

The application notes that Dee Valley Water and Severn Trent Water will be separate companies and Severn Trent Water initially proposed that the board of each Company would have common membership. However, our [board leadership, transparency and governance principles](#) require that there must be significant independent representation on the board of every regulated company. Following discussions with us, Dee Valley Water agreed that their board would have three independent non-executive directors who are independent of Severn Trent Water and the wider Severn Trent plc group. It is important that Dee Valley Water's board can ensure that the interests of Dee Valley Water's customers are represented distinctly from Severn Trent Water. It is also important that it can effectively and robustly challenge costs allocated for shared services and agreed contracts between the two companies.

The following requirements will continue to exist for Severn Trent Water and Dee Valley Water because they are separate licensed companies, albeit both part of the same group.

- The submission of separate business plans and data tables for the two licensed areas. We understand that the business plans for each company are likely to be produced through a common PR19 planning programme, and have a common approach to customer engagement – but the outcome of the engagement could be different which should then drive different activities and service levels;
- The submission of separate annual regulatory accounts and annual performance reports under the separate licences;
- The companies must carry out arm's length transactions between companies, as required under Condition F of their licences;
- The provision of separate statements of assurance from each Board as required;
- Dee Valley Water has stated that it will maintain the Dee Valley Water Customer Challenge Group (CCG) and this CCG will report separately on the plan for the Dee Valley Water area in AMP7; and
- Severn Trent Water has also stated it will complete a statutory transfer scheme which will make Dee Valley Water the legal owner of any Severn Trent Water assets located in Wales. Severn Trent Water and Dee Valley Water's applications were supported by a draft transfer scheme and they will submit their final transfer scheme before the consultation process closes.

4. Other organisations

We have discussed these applications with CCWater, Defra, Welsh Government, Environment Agency, Natural Resources Wales and the Drinking Water Inspectorate in order to obtain initial views and address any initial concerns they may have but without prejudice to the responses that these may provide to this consultation in due course. We understand that each of these organisations are engaging directly with Severn Trent Water and Dee Valley Water and we expect Severn Trent Water and Dee Valley Water to work with them to resolve any concerns they may have.

5. Ofwat Proposal

We are satisfied that there will be minimal impact on customers as a result of this application and that, taking account of any potential detriment against any potential benefit overall, customers of Dee Valley Water and Severn Trent Water will be no worse off up to 2034-35 than if these applications did not go ahead.

Severn Trent Water and Dee Valley Water have both provided modelling to show that they consider that they would be financeable at an appointee level were the applications to go ahead. We consider that on the basis of current information and assumptions, both companies would be financeable if the applications are granted. We have asked the companies to carry out further modelling after the publication of the PR19 methodology so that we can continue to monitor the position.

We acknowledge that Dee Valley Water's wastewater control would not be individually financeable, in order to protect wastewater customers from substantial initial bill impacts.

We are also satisfied that Severn Trent Water and Dee Valley Water will be able to operationally provide water and wastewater services to their new areas.

On this basis we are minded to approve this application subject to the responses we receive to this consultation. We also expect Severn Trent and Dee Valley to provide the further documents and assurances set out in this consultation, including agreeing to the necessary licence modifications as set out below.

The companies have agreed that:

- All assets necessary for the proper operation of water and wastewater companies in the new Severn Trent Water English area and the new Dee Valley Water Welsh area will be transferred at the time of the proposed area changes taking effect.
- The operating manual from Severn Trent Water and Dee Valley Water will include sufficient detail of arms-length agreements between both companies and will be fully compliant with respective licence conditions and RAG 5.
- Due to shared services and agreements between Severn Trent Water and Dee Valley Water proper arrangements will need to be in place to protect Dee Valley Water customers in the event of Severn Trent Water entering special administration and to protect Severn Trent Water customers in the event of Dee Valley Water entering special administration.

- Due to shared services and agreements between Severn Trent Water and Dee Valley Water proper arrangements will need to be in place to protect Dee Valley Water customers and Severn Trent Water customers in the event of either company being sold by Severn Trent Plc.

As set out above, a necessary consequence of Ofwat's proposal in relation to the applications is that licence changes are required to make the relevant changes to price controls as well as making any relevant changes to allow Dee Valley Water to be a water and wastewater company. In addition, to support the finance, governance and operational arrangements between Severn Trent and Dee Valley Water, both Severn Trent Water and Dee Valley Water have agreed in principle to accepting the most recent set of financial ring fencing conditions (Licence Condition P).

We will publish a consultation on the proposed licence modifications in December, before this consultation closes. While drafting of the licence modifications is not yet finalised, we have included a description of the most substantial modifications we expect to be made; namely Condition P (ring fencing) and Condition B (changes relating to price controls) to illustrate the sorts of licence commitments we expect from Severn Trent Water and Dee Valley Water. We expect the conditions on which we will consult shortly will be substantially in this form. There may be other areas of the licence that need to change as a consequence of the proposal in this consultation.

Our proposal to approve the applications are dependent on the required licence modifications being accepted and taking effect on or before the proposed appointment and variations in this consultation take effect.

6. Deadline for responses and next steps

We are seeking feedback and comments on the proposals set out in this consultation, and invite comments no later than 10 January 2018.

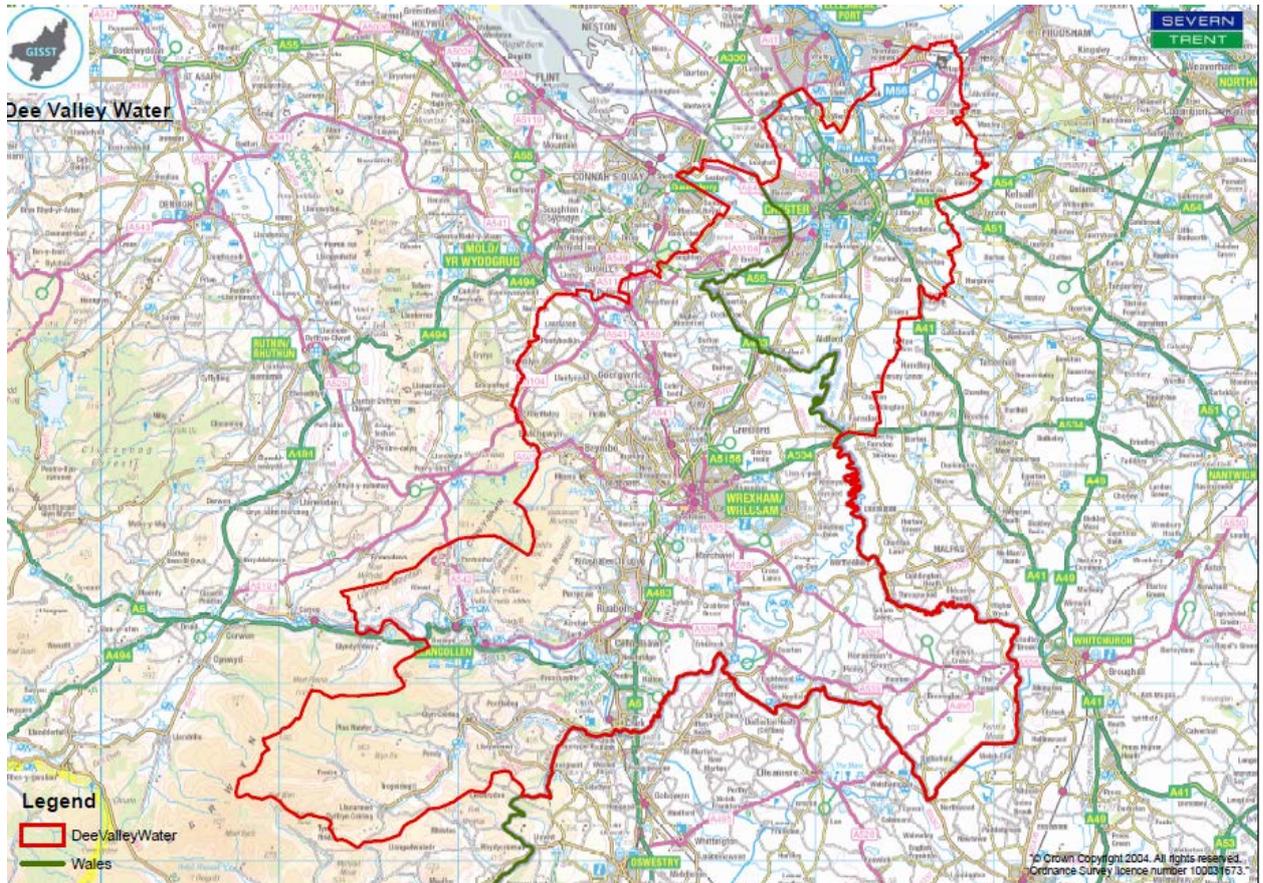
We will reflect on comments received and intend to notify our stakeholders of our decision in January 2018.

If the application is successful the amended licences will take effect from 1 April 2018.

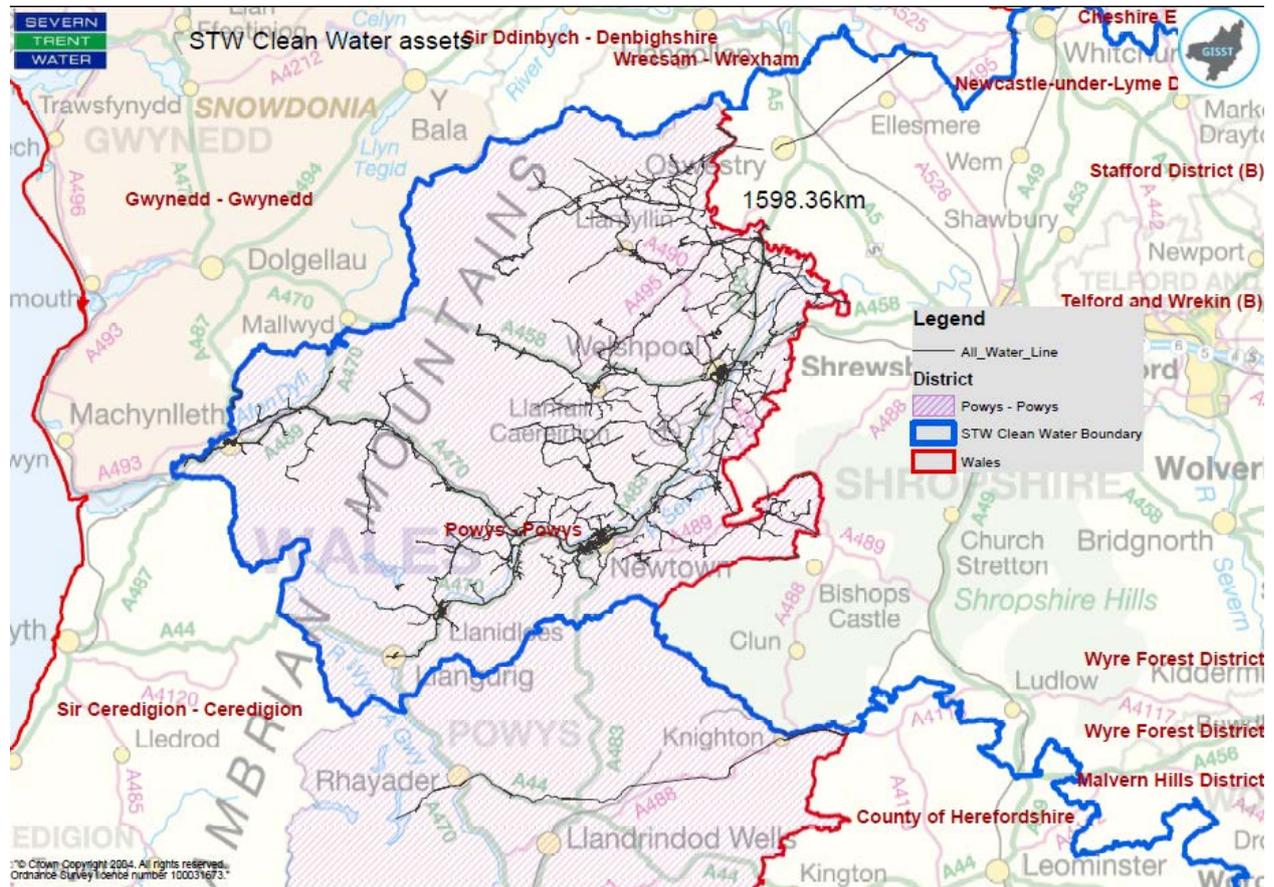
If you would like to discuss any aspect of this consultation document, please use the contact details on page 2 of this document.

7. Appendix 1 – Maps showing Chester and Powys Sites

Dee Valley Water area. All the Dee Valley Water area on the English side of the border is the Chester Site:



Part of Severn Trent Water's current area showing the Powys Site:



8. Appendix 2 – comparison of differences between Severn Trent Water and Dee Valley Water’s codes of practice

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
Code of practice for domestic customers	Severn Trent Water Codes of Practice	<p>Severn Trent Water's Codes of Practice provides customers with greater flexibility, especially regarding payment plans and dates whereas Dee Valley has a more localised personal approach e.g. offering home visits for housebound customers to explain bills. The key headlines are:</p> <p>Opening hours - For Severn Trent Water’s billing call centre vs the Dee Valley Customer Accounts Department</p> <p>Communication – Severn Trent Water have a greater number of communications channels and social media specifically referenced.</p> <p>Metered customers – Dee Valley Water bill 4 times a year, Severn</p>	<p>In general, Severn Trent’s customer offering exceeds Dee Valley’s.</p> <p>Severn Trent Water has committed to providing improvements in service to DVW customers, including greater access to customer service out of normal office hours. Access to more diverse communication channels will also be provided.</p> <p>For customers used to personalised service, SVT’s overall approach could represent a change and we are considering how to address this.</p>

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
		<p>Trent Water bill twice per year. There is no difference in the frequency of meter reads – Dee Valley Water have 3 based on estimates.</p> <p>Final meter reading – Severn Trent Water customers have to give 5 days notice whereas Dee Valley Water do this in 2 working days.</p> <p>Contact Details - Dee Valley Water provide contacts for other organisations e.g. DWI, health protection agency and environmental health at local councils</p>	
<p>Code of practice for the exercise of pipe laying practices in private land</p>	<p>Severn Trent Water Codes of Practice - Section 8 - pipe laying in private land</p>	<p>There is very similar wording and phrasing throughout. The only key differences are:</p> <p>Regulation - Dee Valley Water adhere to the Welsh Ministry of agriculture, fisheries and food (MAFF) and Severn Trent adhere to DEFRA.</p> <p>Detail - In some areas Dee Valley Water goes into more detail</p>	<p>In general, Severn Trent approach matches Dee Valley Water. In future the realigned Welsh company (including areas currently served by Severn Trent Water) will adhere to MAFF guidelines and Severn Trent England will follow DEFRA guidance.</p>

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
		<p>than Severn Trent Water i.e. for agent costings Dee Valley Water cites a reference scale for fees and breakdown of ease of payment consideration (Dee Valley Water pay 50% on proof of title and 50% on completion of the documentation)</p>	
<p>Code of practice for the collection of unpaid charges - household customers</p>	<p>Severn Trent Water Codes of Practice - Section 4 - Your Water Bill and Section 5 - Help Paying Your Bill</p>	<p>Key themes are extremely similar. There are some differences in the stages of debt recovery but both follow a similar pattern: multiple warnings before proceeding to county court. Dee Valley Water could engage a debt collection agency at this point.</p> <p>Severn Trent Water has a charitable trust providing assistance to customers in debt whereas Dee Valley Water does not.</p>	<p>In general, Severn Trent Water service exceeds Dee Valley Water.</p> <p>On realignment of borders Dee Valley Water will ensure that former Severn Trent Water customers retain access to a charitable trust fund, although this will need to be separated from the fund for Severn Trent Water England. Dee Valley Water is also looking to extend this provision to former DVW customers.</p>
<p>Guaranteed standards scheme</p>	<p>Severn Trent Water Codes of Practice - Section 9 - Our guaranteed</p>	<p>Overall Dee Valley Water offers a higher value GSS for most areas against GSS. The majority of the exemptions are the same.</p>	<p>Dee Valley Water exceeds Severn Trent Water.</p> <p>Severn Trent Water will retain the higher level of</p>

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
	Standards Scheme		payments currently applied to Dee Valley Water customers. Severn Trent Water will also extend this to former customers ; since Chester will become part of the English company, this includes the 4 million existing Severn Trent Water customers in England as well as Wales.
Code of practice for leakage business and household customers	Severn Trent Water Codes of Practice - Section 7 - Working to reduce your leakage	Majority of areas in this space align however there are two key areas of difference: Bursts on private property – Dee Valley Water will help to locate the leak and repair the leak free of charge/for a reduced cost if under £220. Severn Trent Water stopped offering free repairs to all customers in 2015. Severn Trent Water will provide advice and have an approved plumber scheme (offering fixed charges for leak repairs) but will only undertake repairs under section 75 (where wastage is causing an issue) or where the customer would struggle to pay.	Dee Valley Water offer exceeds SVT. Severn Trent took a conscious decision to stop providing free leak repairs in 2015. Although Severn Trent Water had historically done work on private property to help manage leakage, this was at odds with the approach on Private Drains and Sewers. When Private Drains and Sewers (PDaS) were adopted in 2011, Severn Trent Water says that they were careful to avoid work on the customer side because this would foreclose the market to drainage contractors, whose work was already being reduced by the adoption of PDaS.

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
		<p>Legislation - DV code is from 2012 and under Welsh legislation where there is no business competition for water supplies under 50 Ml/a and no competition for wastewater services. Dee Valley Water policy applies to businesses as well as households.</p>	<p>Severn Trent Water adopted a consistent approach for private supply pipes at the start of AMP6.</p> <p>Irrespective of whether the border realignment happens or not, Severn Trent Water does not consider it is right for them to work on private assets except unless there is a risk to their network or public health (s75). Severn Trent Water will therefore align the Dee Valley Water's area with Severn Trent Water's approach in due course. There is a market for repairs on private pipe repairs, and performing free repairs deprives plumbers of work.</p> <p>Severn Trent Water says that they are generally supportive of legislation to change the ownership of private supply pipes which is being considered by the Welsh Assembly Government.</p>

Dee Valley Documentation	Severn Trent Equivalent	Key Observations	Exceeds or Matches
			<p>Severn Trent Water says that they will take the same steps as they took to mitigate this change as with the STW region back in 2015 (e.g. establishing an approved plumber scheme with fixed rates for leak repairs).</p>
<p>Additional services for elderly and disabled customers, customers with medical conditions and customers with special needs</p>	<p>Referenced throughout</p>	<p>In code of practice Severn Trent Water states some additional services are for those with some 'medical conditions' whereas Dee Valley Water explicitly states the specific conditions covered.</p>	<p>Matches – differences in wording aside, there is an equivalent level of service.</p>

9. Appendix 3 – Proposal to allocate performance commitment levels and ODIs between the two companies if the application is successful

The tables below details how Severn Trent Water are proposing to split the PR14 performance commitment levels and outcome delivery incentives (ODIs) for Severn Trent Water and Dee Valley Water between the two new companies if the application is successful.

The references in this table relate to the outcome performance commitments set out at PR14 for each company, and [set out on our website](#) as part of our final determinations. Further detail on each commitment and ODI is available there.

Table 1: Severn Trent Water's PR14 ODIs

Please note: outperformance payments / underperformance penalties are referred to here as out / under for simplicity.

We note that when average of historical performance to split the target for leakage. This maintains the same % reduction in both areas since the initial PR14 target was based on a % reduction from a historic baseline over the AMP.

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
WA1	Number of complaints about drinking water quality	Out/under	Proportion of total customers	9,922	9,922	70	70	No.	Proportion of population
WA2	Compliance with drinking water quality standards	Under	Same target for all companies	100	100	100	100	%	Customer postcode
WA3	Asset stewardship : number of sites with coliform failures	Under	Proportion of WTW in Wales (round to zero)	<6	<6	0	0	No.	Asset location
WA4	Successful catchment management schemes	Out/under	Location of proposed schemes	12	12	0	0	No.	Location of scheme NGR Linked to asset location that has benefitted
WB1	Resource efficiency (amount of water we take out of the environment)	Reputation	Same target	216	216	213	213	l/p/d	Population by property split by WIS
WB2	Leakage levels	Out/under	Average proportion of historic leakage in the two regions	423.5	418.6	5.5	5.4	ML/d	Population by property split in DMA

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
									Population by property split by WIS
WB3	Speed of responses in repairing leaks (% fixed within 24 hours)	Out/under	Same % in each region	95	95	100	100	%	Asset location
WB4	Number of minutes customers go without supply each year	Out/under	Same target per property	9.4	9.4	8.0	8.0	Mins/prop/yr	Customer postcode
WB5	% of customers with resilient supplies (those who benefit from a second source of supply)	Out/under	Target split based on start of AMP performance % ⁶	N/A	78.00	N/A	29.4	%	Population by property split by WIS

⁶ Maintained Welsh %, and adjusted English % to account for smaller denominator.

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
WB6	Asset stewardship: mains bursts	Under	Split based on Km of main in each region	6726	6726	179	179	No.	Asset location
WB7	Customers at risk of low pressure	Out/under	Split total number, with target based on current performance. Same % decrease in both areas for last 2 years of AMP.	229	229	21	21	No.	Customer postcode
WB8	Restrictions on use	Out/under	Nil in both areas	0	0	0	0	No.	Customer postcode
WB9-14	Birmingham resilience	Under	England only	Completion	Completion	N/A	N/A	N/A	England (not transferred to DVW)
WC1 SB1 (ww)	Customer value for money – Customers rating our services as good value for money	Out/under	issue with measurement – England only	53%	53%	N/A	N/A	%	Customer postcode

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
WD1 SC1 (ww)	Improvements in river water quality	Out/under	Based on location of target areas – discrete	N/A	31	N/A	0	Points	Asset location – linked to improvement location of River
WD2 SC3 (ww)	Asset stewardship : environmental compliance	Under	Same % target for both areas	100	100	100	100	%	Asset location
WD3 SC4 (ww)	Biodiversity improvements (hectares)	Out/under	Based on location of target areas – discrete.	N/A	409	N/A	0	hectares	Location of scheme NGR
WD4	Sites with eel protection at intakes	Reputation	Based on location of intakes – discrete.	Progress milestone				No	Asset location
WE1	Size of our carbon footprint	Out/under	Base target on % of current power costs in region.	218	214	2	2	ktCO2e	Asset location (possible link to financial burden %)
WF1 SE1	Improved understanding of our services through education	Reputational	Base target split on current population served data	119,160	124,125	840	875	No	Customer postcode

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
SA1	No. of internal sewer flooding incidents	Out/under	Base target split on sewer connections	919	885	8	7	No	Sewer connections
SA2	No. of external sewer flooding incidents	Out/under	Base target split on sewer connections	7276	7161	60	59	No	Sewer connections
SA3	Partnership working (measure of joint initiatives on flooding)	Out/under	Based on location of projects – discrete.	N/A	21	N/A	0	No.	Location of scheme NGR
SA4	Asset stewardship – blockages	Under	Split target based on Km of sewers in each area	<48,997	<48,607	<296	<293	No.	Asset location
SA5	Statutory obligations (section 101a schemes connectable properties)	Reputation	Split target based on number of properties in each area which are associated with 101A schemes.	N/A	312	N/A	0	No.	Location of scheme NGR

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
SC2	The number of category 3 pollution incidents	Out/under	Proportion of historic pollutions in the two regions	364	364	10	10	No.	Causing asset location
SC5	Number of sustainable sewage treatment solutions	Out	England only	0	0	0	0	No.	Asset location
SC6	Number of serious pollution incidents	Reputation	Proportion of historic pollutions in the two regions	2	0	0	0	No.	Causing asset location
SC7	Overall environmental performance	Out/under	When split, the target for two (of four) of these components was 0. As such, could have received payment for no activity. Inappropriate, so this “not applicable” to Wales	N/A	3	N/A	N/A	index	Asset location
SC8	The number of category 4 pollution incidents	Reputation	Proportion of historic pollutions in the two regions	174	174	8	8	No.	Causing asset location

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England		Wales		Unit	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5		
SD1	Size of carbon footprint	Out/under	Proportion of electricity usage in each region	206	210	2	2	ktCO2e	Asset location (possible link to financial burden %)
RA1	Customer satisfaction with their service (based on a customer survey)	Reputation	Same target; however, issue with measurement	UQ	UQ	UQ	UQ	Index	Customer postcode
RA2	Customers' experience of dealing with us (based on Ofwat's SIM)	Out/under	Same target of UQ - based on new area (combined SVT Wales and DVW Wales).	UQ	UQ	UQ	UQ	Index	Customer postcode
RB1	Number of customers helped by a review of their tariff and water usage and/or supported by our social fund	Reputation	Based on current uptake of social tariff	49,750	49,750	250	250	No.	Customer postcode
RB2	% of customers who do not pay	Reputation	Same target in both	2.7	2.7	2.7	2.7	%	Customer postcode

Table 2: Dee Valley Water's PR14 ODIs

	Our Measure of Success	Incentive type	Split of PC level England / Wales	England					Wales		Units	England/ Wales performance split
				Yr 4	Yr 5	Yr 4	Yr 5					
A1	Number of discoloured water contacts	Out/under	Same target as measured per 1,000 population	1.01	1.01				1.01	1.01	Per 1,000	Customer postcode
A2	Mean Zonal Compliance	Under	Same % target	100	100				100	100	%	Customer postcode
A3	Delivery of the outcomes of the Legacy Treatment Works major scheme	Under	All Wales	N/A	N/A				N/A	N/A	Completion	Wales only
A4	Delivery of the outcomes of the	Under	Split by scheme	N/A	N/A				Progress milestone	Completion of 4 schemes	Completion	Asset location

B1	Average duration of interruptions	Out/under	Same target for both former DVW areas: set as interruptions per property/year	0.2	0.2	0.2	0.2	Hrs/prop	Customer postcode
B2	Sustainable economic level of leakage	Out/under	Average proportion of historic leakage in the two regions	86.6	86.6	93.8	93.8	l/prop/day	Population by property split in DMA Population by property split by WIS
B3	Security of supply index	Reputation	Same % target for both former DVW areas	100	100	100	100	%	Water resource zones, split by population
B4	Number of mains bursts	Out/under	Split by km of main in each region	67	67	155	155	No.	Asset location
C1	Greenhouse Gas emissions	Reputation	Base target on % of current power costs in region	2195	2192	7545	7535	tCO ₂ e	Asset location

D1	Survey of customers' perception of value for money and affordability	Reputation	Same target; however, note issue with measurement in response to (a)	Improved	Improved	Improved	Improved	comparative	Customer postcode
E1	Per capita consumption and water efficiency target	Reputation	Same per capita target	128.37	127.28	128.37	127.28	l/p/d	Population by property split
E2	Service Incentive Mechanism (SIM)	Out/under	Same target of UQ - based on new area (combined SVT Wales and DVW Wales).	80	80	80	80	index	Customer postcode
F1	Non-household Service Incentive Mechanism (SIM)	Out/under	Same target of UQ – split based on number of NHH customers in each area.	80	80	80	80	index	Customer postcode

10. Appendix 4 – sample licence conditions

Our sample approach to licence conditions P and B are included below.

We need to change Condition B to correct the price controls we set at PR14 for the two companies for 2018-19 and 2019-20 to reflect the new areas and customer bases. This will not have any effect on the two companies taken together, but instead will reflect the new boundaries.

We also intend to include the section which allows in-period determination of outcome delivery incentives (ODIs) for Severn Trent into Dee Valley's licence. This allows the operation of in-period ODIs for customers in the Powys region, who agreed this as part of Severn Trent's PR14 business plan.

We expect the companies to engage with us to provide the relevant proposals for licence changes over the next few weeks.

10.1.1 Condition B

Part IIIA Performance Measure Adjustments

12 This paragraph applies where the Water Services Regulation Authority has notified the Appointee by 31 December in the Charging Year before the Review Charging Year that a Price Control determined under sub-paragraph 9.4 in respect of the Appointee's Wholesale Activities may be adjusted to reflect the Appointee's performance in relation to a specific Outcome or Outcomes. Where this paragraph applies:

- (1) the Water Services Regulation Authority may determine, and the Appointee may by notice given no later than 15 September in the Prior Year refer to the Water Services Regulation Authority for determination, the question whether, in accordance with and subject to sub-paragraph 12(3) below, the level of the Price Control or one of the Price Controls determined under sub-paragraph 9.4 in respect of the

Appointee's Wholesale Activities should be changed for the following Charging Year and, if so, the amount of such change;

- (2) the Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require for the purpose of making a determination pursuant to this paragraph;
- (3) in making a determination pursuant to this paragraph, the Water Services Regulation Authority shall:
 - (a) consider the Appointee's performance in relation to the Outcome or Outcomes in the preceding years and, if relevant, its expected performance in the current year or one or more future years up to, but not including, the next Review Charging Year; and
 - (b) have regard to the proposed adjustments to the level of the relevant Price Control or Price Controls which the Water Services Regulation Authority notified to the Appointee when the Appointee was notified that a Price Control determined under sub-paragraph 9.4 in respect of the Appointee's Wholesale Activities might be adjusted to reflect the Appointee's performance in relation to a specific Outcome or Outcomes;
- (4) no determination shall be made by the Water Services Regulation Authority under this paragraph later than 15 December in the Prior Year.

For these purposes:

- (1) in this paragraph "**Outcome**" means a target or other measure of the performance of the Appointee in relation to the carrying out of the Regulated Activities that the Water Services Regulation Authority has

notified to the Appointee by 31 December in the Charging Year before the Review Charging Year; and

- (2) in this Condition references to a “**Price Control**” include a Price Control whose level has been changed in accordance with a determination made under this paragraph.

...

Part VIII. Price Controls in effect from 1 April 2018

20

- 20.1 From 1 April 2018 this condition B and the determination of the Price Controls notified to the Appointee on 12 December 2014 (“the Determination Letter”) shall have effect in respect of the period ending on 31 March 2020, and in respect of the making of any Interim Determinations, subject to the amendments to the Determination Letter listed in Schedule 1 below which shall take effect in relation to the period from 1 April 2018.

Schedule 1

Replacement provisions inserted into the determination of Price Controls notified to the Appointee on 12 December 2014 (“the Determination Letter”)

- 1 In respect of the Appointed Business’s water services, 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 £XXXX million.

- 2 Table 1 shall be amended as follows:

Table 1 Water services “K” numbers

Charging Year beginning 1 April	K
2016	XX
2017	XX
2018	XX
2019	XX

- 3 In respect of The Price Control for Household Retail Activities the formulae for calculating Revenue modification for charging year y is amended as follows:

Revenue modification for charging year y

$$= \sum_{c=1}^8 (\text{actual customer numbers}_{y,c} - \text{forecast customer numbers}_{y,c}) \cdot \text{modification factor}_{y,c}$$

- 4 The definition of value 'c' in the formula above is amended as follows:

"c = customer type (unmetered water only (former SVT area), unmetered water only (Chester area), unmetered wastewater only, unmetered water and wastewater, metered water only (former SVT area), metered water only (Chester area), metered wastewater only, metered water and wastewater)."

- 5 Table 3 shall be amended as follows:

Table 3 Household retail allowed revenue

Charging Year beginning 1 April	£million
2018	XX
2019	XX

- 6 Table 4 shall be amended as follows:

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

	Revenue modification per:	2018-19	2019-20
1	Unmetered water only customer (former SVT area)	XX	XX
2	Metered water only customer (Chester area)	XX	XX
3	Unmetered water only customer (former SVT area)	XX	XX
4	Unmetered wastewater only customer	XX	XX
5	Unmetered water and wastewater customer	XX	XX
6	Metered water only customer (Chester area)	XX	XX
7	Metered wastewater only customer	XX	XX
8	Metered water and wastewater customer	XX	XX

7 Table 5 shall be amended as follows:

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

	Number of customers	2018-19	2019-20
1	Unmetered water only (former SVT area)	XX	XX
2	Metered water only (former SVT area)	XX	XX
3	Unmetered water only (Chester area)	XX	XX
4	Unmetered wastewater only	XX	XX
5	Unmetered water and wastewater	XX	XX
6	Metered water only (Chester area)	XX	XX
7	Metered wastewater only	XX	XX
8	Metered water and wastewater	XX	XX

20.2 From 1 April 2018 this condition B and the determination of the Price Controls notified to the Appointee on 15 December 2016 (“the Determination Letter”) shall have effect in respect of the period ending on 31 March 2020, and in respect of the making of any Interim Determinations, subject to the amendments to the Determination Letter listed in Schedule 1 below which shall take effect in relation to the period from 1 April 2018.

Schedule 1

Replacement provisions inserted into the determination of Price Controls notified to the Appointee on 15 December 2016 (“the Determination Letter”)

1 Table 1 shall be amended as follows:

Table 1 Business customer group 1, allowed average retail cost components and allowed net margins

Customer type	Units	2018-19	2019-20
XX	XX	XX	

2 Table 2 shall be amended as follows:

Table 2 Business customer group 2, allowed average retail cost components and allowed net margins

Customer type	Units	2018-19	2019-20
XX	XX	XX	

10.1.2 Condition P

The companies have both committed to adopting the most recent ring-fencing conditions and for the new Condition P to be included within the licence. This includes some small modifications agreed by letter on 6 December (published alongside this consultation).

11. Appendix 5 – assurances from companies

While we were considering the applications, we wrote to the companies to seek commitments on particular issues. These commitments are replicated below.

11.1.1 Dee Valley Water – 27 November

Customer services

Across the DVW and STW regions there are small differences in the level of customer service offered. Since the acquisition we are already delivering benefits to our customers, through efficiencies and better service performance. Our proposal will deliver even greater benefits to customers in Wales, for example through:

- higher GSS payments to all of our customers in Wales and not just Wrexham;
- extended communication channels and servicing hours;
- developing future plans that are specific to the needs of our Welsh customers and Welsh regulations; and
- working with our customers and stakeholders in Wales to better understand the affordability challenges and developing as part of our PR19 plans, more effective measures to help vulnerable customers and those struggling to pay.

We understand your desire that these changes are introduced as soon as possible. We are committed to implementing changes to our codes of practice by 1 April 2018, which would allow us sufficient time to engage with our stakeholders, including CCWater and for them to take effect from the date of the licence variation. We will continue working with our customers and our DVW-Customer Challenge Group to develop our future Welsh plans.

Performance commitments

We will uphold our PR14 performance commitments, which we have allocated across the proposed English and Welsh licence area. We will continue working to deliver the excellent service that is underpinned by these commitments.

Licence conditions

We have committed to adopting the most recent ring-fencing conditions and for the new Condition P to be included within the licence. Alongside this condition we are drafting an Operational Services Agreement that documents at a high level the services which STW will be providing in Powys and DVW will be providing in Chester, and the cost allocation methodology for doing so. The legal agreement also includes clauses for procedures for special administration or disposal. We have provided our draft with your team and will provide the final agreement following the NAV consultation.

Tariffs

On average, customers in Powys pay around £20 less for water services than customers in Wrexham. We will continue to operate separate tariff structures for these customers until at least 2020.

At the next price review we expect bills will fall due to a lower cost of capital and the impact of efficiency savings. We intend to use the savings to reduce tariffs for those customers with the highest bills while avoiding any increase for other customers. The extent of this change will depend on the Final Determination and the impact of inflation. We will work with CCWater when implementing changes to our tariffs.

For our Powys wastewater customers, due to the rural nature of the region and low bills (at the end of AMP6 Powys waste bills will be approximately £94 compared to £138 in STW and £227 in Wales†) the income from Powys wastewater customers will not cover operating and financing costs. We do not intend to increase wastewater bills to make the wastewater control financeable in AMP7. We will work with CCWater to consider the appropriate trajectory in future AMPs.

Communications

We recognise that these changes will impact customers in different ways. We are working with CCWater as we develop our communications plan for customers, developers and landlords.

We have discussed this with CCWater on 23 November 2017 and have another meeting scheduled for early December. We will continue to work with CCWater as our plan develops.

11.1.2 Dee Valley Water – 5 December

Additional paragraph for Condition P

We confirm that we accept the new paragraph for Condition P as illustrated below:

'The Appointee shall not, without the consent of the Water Services Regulation Authority and otherwise than in compliance with its directions concerning the valuation of the asset and the treatment of the consideration in the Appointee's accounts, transfer to any Associated Company to which paragraph 6.1 applies any right or asset to which paragraph 4.2 applies.'

Financeability

Our NAV application protects the interests of waste customers in Powys by only allocating a notional RCV – this means the waste control in DVW will not be financeable and Powys customers will continue to benefit from having the lowest waste bills in the UK and £130 cheaper than peers in Wales.

We will not seek to use the financial levers (PAYG and RCV run-off) to address any waste financeability issues, provided the company remains financeable. We will set DVW waste PAYG and RCV run-off consistent with natural rate and historical levels (ie, what occurred at SVT in PR14).

11.1.3 Severn Trent Water – 27 November

Customer services

Across the DVW and STW regions there are small differences in the level of customer service offered. Since the acquisition we are already delivering benefits to our customers, through efficiencies and better service performance. Our proposal will deliver even greater benefits to customers in England and specifically those in the Chester region:

- all customers will receive the higher GSS payments currently offered by Dee Valley;
- customers in Chester will have access to greater communication channels and customer service out of hours, consistent with other Severn Trent customers; and

- customers in Chester will have access to the Severn Trent charitable trust.

We understand your desire that these changes are introduced as soon as possible. We are committed to implementing these changes by 1 April 2018. This allows us sufficient time to engage with our stakeholders, including CCWater and for them to take effect from the date of the licence variation.

Performance commitments

We will uphold our PR14 performance commitments, which we have allocated across the proposed English and Welsh licence area. We will continue working to deliver the excellent service that is underpinned by these commitments.

Licence conditions

We have committed to adopting the most recent ring-fencing conditions and for the new Condition P to be included within the licence. Alongside this condition we are drafting an Operational Services Agreement that documents at a high level the services which STW will be providing in Powys and DVW will be providing in Chester, and the cost allocation methodology for doing so. The legal agreement also includes clauses for procedures for special administration or disposal. We have provided our draft with your team and will provide the final agreement following the NAV consultation.

Tariffs

The average bill for water services in Chester by 2020 is expected to be £146 compared to £158 in Severn Trent and £165 across the industry*. We will continue to operate separate tariff structures for these customers until at least 2020.

At the next price review we expect bills will fall due to a lower cost of capital and the impact of efficiency savings that we will deliver. We intend to use these savings to reduce tariffs, particularly for those customers with the highest bills. The extent of this change will depend on the Final Determination and the impact of inflation. We will work with CCWater when implementing changes to our tariffs.

Communications

We recognise that these changes will impact customers in different ways. We are working with CCWater as we develop our communications plan for customers, developers and landlords.

We have discussed this with CCWater on 23 November 2017 and have another meeting scheduled for early December. We will continue to work with CCWater as our plan develops.

11.1.4 Severn Trent Water – 5 December

Credit ratings and cash lock-up

We confirm that we accept the amended conditions, specifically the edit of section 7.1 and removal of section 7.3 as illustrated below:

7.1 The Appointee must demonstrate its ability to service its debt obligations by complying with paragraph 7.2 other than where the Water Service Regulation Authority agrees that the Appointee does not need to comply with paragraph 7.2, whereupon it must comply with paragraph 7.3.

7.3 Where the Water Services Regulation Authority has agreed that the Appointee is not required to comply with paragraph 7.2, the Appointee must no later than the date on which the Appointee is required to deliver to the Water Services Regulation Authority a copy of each set of accounting statements prepared under Condition F submit to the Water Services Regulation Authority a certificate which states that:

(a) in the opinion of the Board of the Appointee, the Appointee would be able to maintain an Issuer Credit Rating which is an Investment Grade Rating; and

(b) includes a statement of the main factors, including financial ratios and other information, which the Board has taken into account in giving its opinion for the certificate.

Additional paragraph for Condition P

We confirm that we accept the new paragraph for Condition P as illustrated below:

'The Appointee shall not, without the consent of the Water Services Regulation Authority and otherwise than in compliance with its directions concerning the

valuation of the asset and the treatment of the consideration in the Appointee's accounts, transfer to any Associated Company to which paragraph 6.1 applies any right or asset to which paragraph 4.2 applies.'