April 2019

Trust in water

PR19 draft determinations: South West Water draft determination

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PR19 draft determinations: South West Water draft determination

About this document

This appendix sets out for consultation the details of the draft determination of price controls, service and incentive package for South West Water for 2020 to 2025. All figures in this document are in 2017-18 prices except where otherwise stated.

The draft determination sets out:

- the outcomes for South West Water to deliver;
- the allowed revenue that South West Water can recover from its customers;
- how we have determined allowed revenues based on our calculation of efficient costs and the allowed return on capital.

The draft determination covers all five price controls for the 2019 price review (PR19):

- water resources;
- water network plus;
- wastewater network plus;
- bioresources; and
- residential retail.

We have developed this draft determination in accordance with our methodology, our statutory duties and the UK Government's statement of strategic priorities and objectives for Ofwat. We have also had regard to the principles of best regulatory practice to be transparent, accountable, proportionate, consistent and targeted.

The appendices to this document provide more detail and form part of the draft price control determination:

- PR19 draft determinations: South West Water - Cost efficiency draft determination appendix
- PR19 draft determinations: South West Water - Outcomes performance commitment appendix
- PR19 draft determinations: South West Water - Accounting for past delivery appendix
- PR19 draft determinations: South West Water - Allowed revenue appendix

For all other documents related to the South West Water draft determination, please see the draft determinations webpage.

Written representations on this draft determination should be provided to us by 24 May 2019. Final determinations for all companies will be issued in December 2019.

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1. Summary

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that their dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet needs of future customers and protect and improve the natural environment.

Our initial assessment of South West Water's business plan showed it to be one of the best plans in the sector. It leads the sector with its outcome performance commitment and incentives package, where it is pushing itself to go further including in areas particularly important to customers such as reducing pollution incidents and incidents of sewer flooding inside customers' homes. South West Water is also targeting customers who struggle to pay their bills by committing to doubling the number of customers on support tariffs. South West Water has committed to sharing a proportion of its historic outperformance on the cost of debt through Watershare+.

We identified limited interventions to the plan to make sure customers' interests are protected, which South West Water formally accepted. On 31 January 2019, we awarded South West Water's plan fast-track status. The company confirmed its agreement to our interventions and resubmitted relevant data tables on 11 February 2019. These agreed interventions, along with some minor intervention amendments following the review of additional information provided by South West Water, are reflected in this draft determination.

This early draft determination gives South West Water the opportunity to accelerate the delivery of its plans so that customers and the environment get more of what matters sooner.

What the draft determination means for customer bills

Our draft determination for South West Water will cut average bills by 15% in real terms in the 2020-25 period. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in September 2018 and our amended draft determination profile. Average bills are lower than originally proposed by South West Water, reflecting the company accepting our view of efficient costs.

Table 1.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan	£527	£489	£483	£472	£464	£454
Draft determination	£527	£489	£478	£468	£458	£450

What the draft determination will deliver

Our draft determination package includes a full set of performance commitments, specifying the level of service that South West Water commits to deliver for customers and the environment. Each performance commitment also has a financial or reputational incentive to hold the company to account for delivery of these commitments. Table 1.2 below sets out some of the key performance commitments for 2020-2025 and the overall incentive package, further details are in section 2.

Table 1.2: Key commitments for South West Water

Area	Measure
Overall incentive package	Overall ODI package in our draft determination equates to a return on regulatory equity range of -3.2% (P10) to +1.6% (P90).
Key common performance commitments	• 15% reduction in annual level of leakage by 2025 from the 2020 level[1]. • 6% reduction in per capita consumption by 2024-25 • 58% reduction in pollution incidents by 2024-25 • 24% reduction in internal sewer flooding incidents by 2024-25
Bespoke performance commitments	• Biodiversity – Enhancement: 50,000 hectare increase over AMP7 (79%) • Achieve a four star rating on the Environmental Performance Assessment (EPA) carried out by the Environment Agency in 2023-24 and 2024-25 • 38% reduction in external sewer flooding incidents by 2024-25 • 17% reduction in sewer blockages by 2024-25 • 75% customer satisfaction for value for money by 2024-25 • 100% of details of customer on the priority services register checked every 2 years by 2024-25 • 50,000 customers on social tariffs by 2024-25 • 100% of customers find bills affordable by 2024-25

Note: Where the information provided in this table is an estimate of change over time, it may be calculated using reductions from the forecasts of performance that the company has made for 2019-20, which we are not publishing as part of the draft determination, compared against the 2024-25 performance commitment level. Consequently, it may not be possible to calculate the percentage change from the information we provide.

South West Water has committed to applying the principles set out in our July 2018 position statement ‘Putting the sector in balance’ to encourage companies to take the interests of customers into account when determining financial structure. This means it commits to:

- apply the default gearing outperformance sharing mechanism we set out, although South West Water proposes to maintain gearing levels below the 70% trigger threshold in 2020-25;
- through Watershare+, South West Water’s sharing mechanism, share historical outperformance on the cost of debt with customers, with likely payments

[1]The company has committed to reduce its average annual leakage level by 15.8% from its 2019-20 level to its 2024-25 level. The figure here and in the ‘South West Water - Outcomes performance commitment appendix’ is calculated on a three-year average basis to smooth annual variations due to weather.

estimated by South West Water to be around £20 million in 2020-25. Watershare+ will also enable customers to receive shares in the company; and
- dividend and performance related executive pay policies that are linked to delivery for customers.

We identified areas of South West Water's proposals on dividend policy and executive pay which we required the company to address. The company has committed to meet our expectations in these areas and has taken steps to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers.

Allowed revenues

Our draft determination sets out allowed revenue or average revenue for each of the price controls. Table 1.3 sets out the allowed revenues in the draft determination across each price control.

Table 1.3: Allowed revenue, 2020-25 (£ million)

	Water Resources	Network plus - water	Network plus - wastewater	Bioresources	Wholesale Total	Residential retail
Final allowed revenues (£ million)	103.4	1,108.7	1,187.3	118.7	2,518.0	142.2

Note: retail revenue is the sum of the margin, retail costs, and adjustments. The bioresources and residential retail controls are average revenue controls. We have included forecast revenue (in real terms) for these controls to illustrate the total revenue across all controls.

The draft determination includes the early view cost of capital for the wholesale price controls of 3.3% (CPIH deflated) set out in our PR19 methodology. South West Water's business plan incorporated the early view cost of capital. We will update our view of the cost of capital when we publish the draft determinations for the slow-track and significant scrutiny companies in July 2019, and again for the final determinations for all companies in December 2019.

Consistent with our financing duty, we consider that South West Water's draft determination is sufficient for an efficient company, with the notional capital structure, to access funds necessary to finance their activities on reasonable terms.

Summary of interventions

This draft determination includes limited interventions to South West Water's business plans and agreed actions. The key interventions were to:

- improve its Environment Agency Environmental Performance Assessment (EPA) rating by including a penalty only performance commitment to achieve a four-star rating by 2024-25;
- increase the stretch on some key performance commitments, including stronger underperformance payments;
- accept our view of efficient costs; and
- formally adopt the default gearing benefit sharing mechanism despite South West Water's forecast gearing being below the sharing threshold.

We expect the company to ensure its performance related executive pay policy for 2020-25 is stretching. We expect the company to ensure the explanation and application of its dividend and performance related executive pay policies are transparent to customers.

Next steps

The procedural benefit of an early draft determination for fast-track companies is strengthened by early certainty on specified components of the draft determination related to outcomes and the cost allowance. South West Water has chosen to opt in to the early certainty principle.

We will publish South West Water's final determination in December 2019 after considering representations on the draft determination.

2. Outcomes

The outcomes framework is a key component in driving companies to focus on delivering the objectives that matter to today's customers, future customers and the environment in the 2020-25 period and beyond. Outcomes define the service package that companies should deliver for their customers and their incentives to do this.

We have two key tools to ensure that companies deliver the right outcomes for customers, performance commitments and ODIs. Performance commitments specify the services that customers should receive and set out in detail the levels of performance that the companies commit to achieve within the five year period from April 2020 to March 2025. ODIs specify the financial or reputational consequences for companies of outperformance or underperformance against each of these commitments. The framework gives companies the freedom to innovate and explore to find the most cost-effective way of meeting these outcomes.

Companies have engaged directly with their customers to develop a package of performance commitments and outcome delivery incentives in line with the guidance we set out in the PR19 methodology. Customer Challenge Groups (CCG) provide challenge on the quality of each company's engagement with their customers. South West Water's CCG considers that the customer engagement was robust and provided confidence that performance commitments reflected customer views.

South West Water's performance commitments and outcome delivery incentives for the 2020-25 period are summarised in Table 2.1 (Common performance commitments) and Table 2.2 (Bespoke performance commitments) below. These reflect the common performance commitments required by the PR19 Methodology and the bespoke performance commitments proposed by the company in its business plan after consultation with its customers. They include the revisions accepted by the company in response to our 31 January 2019 initial assessment of business plans (IAP) publication (including the actions we placed on the company with respect to its performance commitments and outcomes delivery incentives).

To achieve fast-track status South West Water agreed to a series of actions on its performance commitments and ODI package. These resulted in increases in the stretch on some key performance commitment targets (Duration of interruptions in supply, Internal sewer flooding and Number of pollution incidents cat 1 – 3 (waste only)), a reduction of the potential outperformance payments and an increase of the potential underperformance payments on a number of material ODIs (e.g. compliance with water quality standard, internal sewer flooding, number of pollution incidents cat 1 – 3 (waste only), number of mains bursts, sewer collapses and numeric compliance) and from the overall package in absolute terms. The further material interventions we are making in the draft determination include:

- Increasing the ODI underperformance rate for Resilient water and wastewater services on the Isles of Scilly to ensure the cost allowance is fully returned to customers if the company's licensed area of appointment is not extended to include the Isles of Scilly;
- Imposing an ODI underperformance rate for efficient delivery of the new Knapp Mill WTW and efficient delivery of the new Alderney WTW to ensure an adequate part of the cost allowance is returned to customers if the schemes are delayed or do not proceed;
- Reducing the enhanced ODI outperformance rate for internal sewer flooding to two times the standard rate; and
- Setting the underperformance collar for per capita consumption to the company's estimated P10 performance level.

Table 2.1: Summary of performance commitments: Common PCs

Name of Common Performance Commitment	Type of Outcome Delivery Incentive (ODI)	Price controls ODIs will apply to
Water quality compliance (CRI) [PR19 SWB_PC A1]	Financial – Under; In-period	Water network plus
Water supply interruptions [PR19 SWB_PC A2]	Financial - Out & under; In-period	Water network plus
Leakage [PR19 SWB_PC C2]	Financial - Out & under; In-period	Water network plus
Per capita consumption [PR19 SWB_PC C3]	Financial - Out & under; End-of-period	Water network plus
Mains repairs [PR19 SWB_PC A3]	Financial - Out & under; In-period	Water network plus
Unplanned outage [PR19 SWB_PC A4]	Financial – Under; In-period	Water network plus
Risk of severe restrictions in a drought [PR19 SWB_PC D1]	Reputational	N/A
Priority services for customers in vulnerable circumstances [PR19 SWB_PC E6]	Reputational	N/A
Internal sewer flooding [PR19 SWB_PC B1]	Financial - Out & under; In-period	Wastewater network plus
Pollution incidents [PR19 SWB_PC F1]	Financial – Under; In-period	Wastewater network plus
Risk of sewer flooding in a storm [PR19 SWB_PC D2]	Reputational	N/A
Sewer collapses [PR19 SWB_PC B3]	Financial - Out & under; In-period	Wastewater network plus
Treatment works compliance [PR19 SWB_PC B6]	Financial – Under; In-period	Wastewater network plus
C-Mex: Customer measure of experience [PR19 SWB_PC E1]	Financial - Out & under; In-period	Residential retail
D-Mex: Developer services measure of experience [PR19 SWB_PC E4]	Financial - Out & under; In-period	Water network plus; Wastewater network plus

Table 2.2: Summary of performance commitments: Bespoke PCs

Name of Bespoke Performance Commitment	Type of Outcome Delivery Incentive (ODI)	Price controls ODIs will apply to
Taste, smell and colour contacts [PR19 SWB_PC A5]	Financial - Out & under; In-period	Water network plus
Water restrictions placed on customers [PR19 SWB_PC C1]	Financial – Under; End-of-period	Water resources; Water network plus
External sewer flooding incidents [PR19 SWB_PC B2]	Financial - Out & under; In-period	Wastewater network plus
Sewer blockages [PR19 SWB_PC B4]	Financial - Out & under; In-period	Wastewater network plus
Odour contacts from wastewater treatment works [PR19 SWB_PC B4]	Financial - Out & under; In-period	Wastewater network plus
Descriptive compliance [PR19 SWB_PC B7]	Financial – Under; In-period	Wastewater network plus
Total wastewater treatment works (WWTW) compliance [PR19 SWB_PC B8]	Reputational	N/A
Compliance with sludge standard [PR19 SWB_PC B9]	Financial – Under; In-period	Bioresources (sludge)
Resilience in the round – wastewater [PR19 SWB_PC D3]	Financial - Out & under; In-period	Wastewater network plus
Resilience in the round – water [PR19 SWB_PC D4]	Financial - Out & under; In-period	Water network plus
Operational contacts resolved first time – water [PR19 SWB_PC E2]	Financial - Out & under; In-period	Water network plus
Operational contacts resolved first time – wastewater [PR19 SWB_PC E3]	Financial - Out & under; In-period	Wastewater network plus
Customer satisfaction with value for money [PR19 SWB_PC E5]	Reputational	N/A
British Standard for inclusive service provision [PR19 SWB_PC E7]	Reputational	N/A
Overall satisfaction of services received on the PSR [PR19 SWB_PC E8]	Reputational	N/A
Number of pollution incidents cat 1-3 (water only)	Financial – Under; In-period	Water network plus

Name of Bespoke Performance Commitment	Type of Outcome Delivery Incentive (ODI)	Price controls ODIs will apply to
[PR19 SWB_PC F2]		
Biodiversity – Compliance [PR19 SWB_PC F3]	Reputational	N/A
Biodiversity - Prevent Deterioration [PR19 SWB_PC F4]	Reputational	N/A
Biodiversity – Enhancement [PR19 SWB_PC F5]	Financial - Out & under; End-of-period	Water resources; Water network plus
EPA [PR19 SWB_PC F6]	Financial – Under; In-period	Water resources; Wastewater network plus
Bathing water quality [PR19 SWB_PC H1]	Financial - Out & under; End-of-period	Wastewater network plus
Abstraction incentive mechanism [PR19 SWB_PC H2]	Financial - Out & under; In-period	Water resources
Installation of AMR meters [PR19 SWB_PC G1]	Reputational	N/A
Number of customers on one of our support tariffs [PR19 SWB_PC G2]	Reputational	N/A
Voids for residential retail [PR19 SWB_PC G3]	Reputational	N/A
Percentage of customers who find their water bill affordable [PR19 SWB_PC G4]	Reputational	N/A
Efficient delivery of the new Knapp Mill WTW [PR19 SWB_PC A6]	Financial – Under; End-of-period	Water network plus
Efficient delivery of the new Alderney WTW [PR19 SWB_PC A7]	Financial – Under; End-of-period	Water network plus
Resilient water and wastewater services on the Isles of Scilly [PR19 SWB_PC D5]	Financial – Under; In-period	Water network plus; Wastewater network plus

The ‘South West Water - Outcomes performance commitment appendix’ sets out in detail our draft determination of each of the performance commitments and outcome delivery incentives proposed by the company, and further detail on each of our interventions in the company’s performance commitments and outcome delivery incentives following our 31 January 2019 initial assessment of plans publication.

Figure 2.1 and Figure 2.2 below provide an indication of the financial value of each of South West Water’s Outcome Delivery Incentives (taking into account the impact of our draft determination interventions) showing how much they would have to pay out to customers if they underperformed to the P10 level and how much they would gain if they over performed to the P90 level. The figures cover common and bespoke commitments respectively. Table 2.3 below provides an indication of the financial value of the overall package at the upper and lower extreme levels of performance (expressed as a percentage point impacts on RoRE) and the overall impact of our draft determination interventions. The estimates are based on the company's own view of the plausible bounds of performance. The P90 is the performance threshold at which there is only a 10% chance of outturn performance being better. The P10 is the performance threshold at which there is only a 10% chance of outturn performance being worse.

Figure 2.1: Projected P10 penalties and P90 payments for common performance commitments over 2020-25 (£ million)

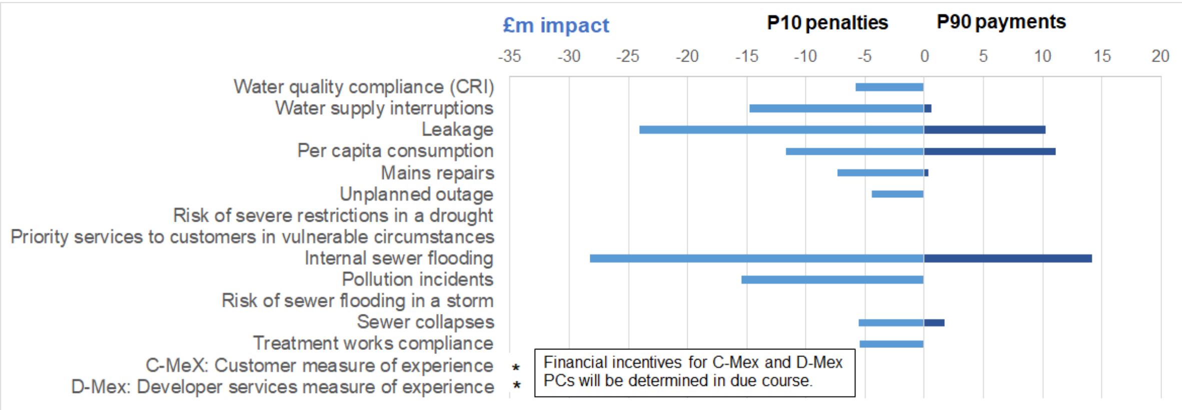


Figure 2.2: Projected P10 penalties and P90 payments for Bespoke Performance Commitments over 2020-25 (£ million)

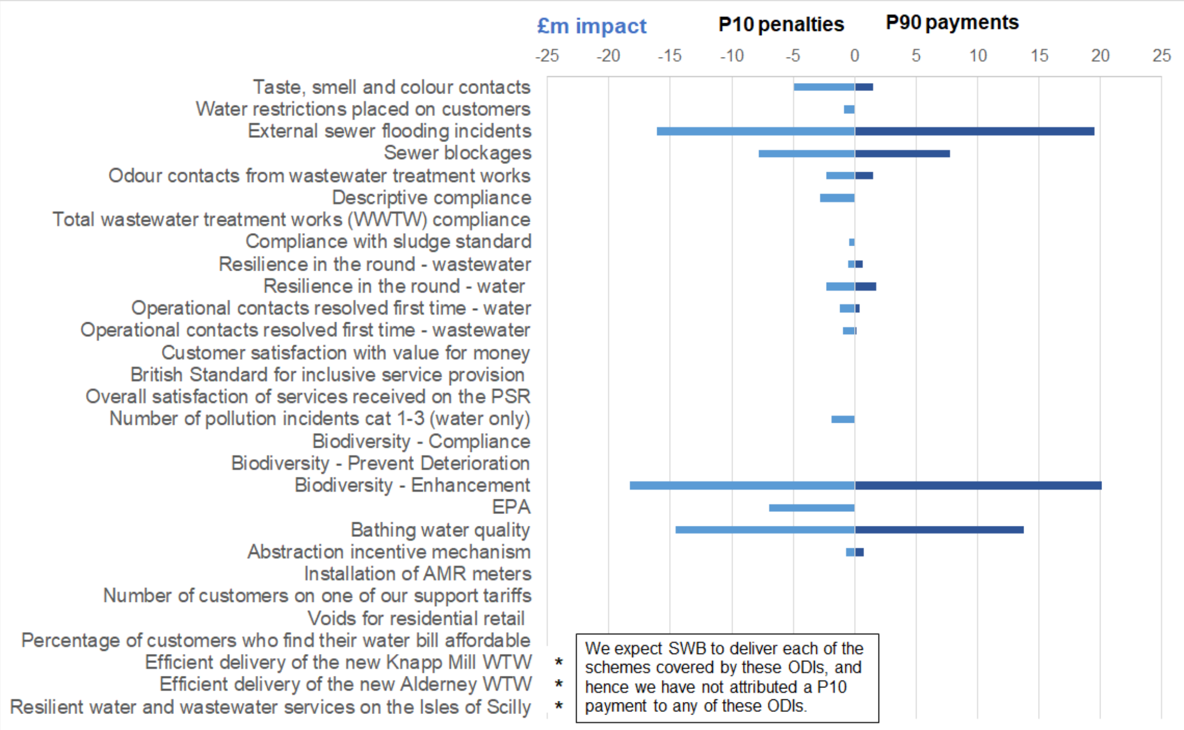


Table 2.3: Impact of draft determination interventions on RoRE range

	Sep 2018 business plan		Draft determination	
	% of 5 year regulatory equity		% of 5 year regulatory equity	
	p10	p90	p10	p90
South West Water	-2.8%	2.4%	-3.2%	1.6%

We said in the PR19 methodology that we expect companies to propose approaches to protecting customers in case their ODI payments turn out to be much higher than expected. We explained in our initial assessment of business plans Technical Appendix Delivering Outcomes for Customers published on 31st January that we are asking all companies to commit to put in place additional protections for customers, where we consider protections are not adequate to protect customers from high outperformance payments.

The company has applied ODI payment caps and collars across a number of its material common and bespoke performance commitments, including wastewater

(Internal/External sewer flooding and Sewer blockages) and water (Leakage, PCC, Biodiversity – Enhancement, Bathing water quality).

The company has accepted our mechanism for sharing with customers through bill reductions 50% of their incremental outperformance payments once the outperformance payments in any year reach 3% of their wastewater or water RoRE for that year. We will be undertaking further work on the detail of the mechanism and the process for annual reconciliation which we plan to publish for stakeholder views alongside the slow-track and significant scrutiny draft determinations in July. We will publish our final decisions on these aspects of the mechanism (and including its incorporation into the company's price controls) as part of the final determinations in December.

In our PR19 methodology, we set out that we would replace the current Service Incentive Mechanism (SIM) with the C-Mex for customers and introduce a new service incentive for developers, D-Mex. We have worked with stakeholders including companies, CCWater and developer customers to develop both mechanisms and would like to acknowledge and thank those who have contributed to the working groups. We have piloted the C-Mex and D Mex mechanisms in 2018 and will run both mechanisms in a shadow year in 2019. We published our guidance for the C-Mex and D-Mex shadow year in early March. We will finalise our detailed approach to C-Mex and D-Mex taking account of the learnings from the shadow year. As part of the slow -rack and significant scrutiny draft determinations process we will publish our minded to positions on detailed working of C-Mex and D-Mex, and will seek stakeholder views and further input. We will publish our decision on final C-Mex and D-Mex incentive design for 2020-2025 as part of the final determinations in December.

We will finalise the company's performance commitments and outcome delivery incentives in the light of representations on this draft determination and our draft determinations for slow-track and significant scrutiny companies, to be published in July, so that these can be reflected as appropriate in the company's final determination to be published in December. Any changes that we make will be subject to the provisions of the "early certainty" principle agreed with the company.

The outcomes framework sits in the broader context of the company's statutory and licence requirements for service delivery. Independently of the outcomes framework, each company also has to ensure that it complies with its statutory obligations, or risk enforcement action. If a company's performance falls below the level set for a performance commitment, we will consider whether this is indicative of wider compliance issues to the detriment of consumers and whether enforcement action, with the potential for remedial and fining measures, is warranted.

3. Cost allowances

We set out in our PR19 methodology that we expect company business plans to show a step change in efficiency. South West Water submitted a plan for 2020-25 that is broadly efficient in water resources, network plus water and network plus wastewater. Its proposed expenditure in bioresources and residential retail was over 10% less efficient than our view of costs. We challenged South West Water's proposed costs to ensure customers pay only for efficient costs. Where appropriate, we also made interventions to protect customers if the proposed investment is not delivered.

3.1. Wholesale total expenditure

Our approach to setting total expenditure (totex) allowances is detailed in our initial assessment of business plans publication 'Technical Appendix 2: Securing cost efficiency'. In this section we set out our totex allowance for 2020-25 for the water resources; network plus water; bioresources and network plus wastewater. In the appendix we provide more detailed information on our cost challenge for enhancement expenditure, our allowance for cost adjustment claims and transitional expenditure and how we will deal with the uncertainty in WINEP.

Table 3.1 shows the totex allowances by year and by price control for the period 2020-25. We have phased our allowed totex over 2020-25 using the company business plan totex profile.

Table 3.1 Totex[1] (excluding pension deficit recovery) by year for wholesale controls, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water Resources	16.2	16.7	15.9	15.0	14.8	78.7
Water network plus	152.5	166.4	184.0	175.5	170.0	848.4
Wastewater network plus	186.2	182.7	167.4	166.1	153.8	856.2
Bioresources[2]	17.8	18.2	18.7	18.4	18.1	91.2
Total	372.7	383.9	386.0	375.1	356.7	1,874.4

1 Totex includes all costs except pension deficit recovery costs. Totex includes third party costs (i.e. costs that are offset by revenues from third parties, such as bulk supply of non-potable water) and it is stated here before removing any grants and contributions we expect the company to receive. These are shown in the table below.

2 The bioresources control is an average revenue control. The totex allowance in our draft determination is based on a forecast level of tonnes of dry solids.

Table 3.2 sets out the build-up of our totex allowance from base and enhancement costs. Base expenditure refers to routine, year on year costs, which companies incur in the normal running of their business. Enhancement expenditure refers to investment for the purpose of enhancing the capacity or quality of service beyond current levels. Enhancement expenditure may be driven by factors, including population growth, new statutory obligations and improvements in areas important to customers. The following sections provide more information on base and enhancement expenditure.

Our cost assessment framework allows companies to submit cost adjustment claims to allow for unique operating circumstances, legal requirements or atypical expenditure. The claims can relate to both base and enhancement costs. Our totex allowance includes all adjustments made and the 'South West Water - Cost efficiency draft determination appendix' sets out the rationale for our decisions.

Table 3.2: Totex by wholesale price control and type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
Base expenditure	70.9	650.6	597.9	89.3	1408.8
Enhancement expenditure	7.8	173.0	250.3	1.9	432.9
Third party costs	0.0	24.8	8.0	0.0	32.7
Total – excluding pension deficit recovery	78.7	848.4	856.2	91.2	1,874.4
Pensions deficit recovery costs	0.4	8.2	7.5	1.5	17.5
Total	79.0	856.5	863.6	92.7	1,891.9

Note: We are displaying pension deficit recovery costs separately as they are not included in the calculation for PAYG (see section 4.2).

3.2. Base expenditure

For our draft determinations, we apply an efficiency challenge to base expenditure proposed by companies. Our efficiency challenge is based on cost performance within the sector as well as on wider factors.

To come to our view of efficient base costs our initial benchmark is "upper quartile" performance within the sector. Such a benchmark provides an efficiency challenge to

75% of the water companies to catch up with the top 25% of companies in the sector. We look beyond the water sector as well. We apply further stretch to our view of costs based on evidence of ongoing productivity improvement in the wider economy as well as evidence of the efficiency gains from the totex and outcomes framework. Our efficiency challenge is based on comparative assessment.

We use econometric models to derive this challenge. Our challenge to company business plans should be considered 'in the round'. As a consequence companies receive our modelled allowance even if their proposed costs are below our allowance within a given service area. There are, however, cost factors that do not lend themselves to this approach. These are termed unmodelled base costs and include business rates, third party costs, abstraction charges and typically costs relating to the Traffic Management Act and occasionally the Industrial Emissions Directive. For South West Water no allowance was necessary for costs relating to the Traffic Management Act nor for the Industrial Emissions Directive.

Our approach to setting an efficiency challenge to modelled base costs is set out in our initial assessment of business plans 'Technical Appendix 2: Securing cost efficiency'.

Table 3.3: Base expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Service	Company business plan - base cost	Modelled base costs efficiency adjustment	Unmodelled base costs challenge	Base cost allowance
Wholesale water	676.3	45.8	-0.6	721.5
Wholesale wastewater	713.4	-25.7	-0.5	687.2
Total	1,389.7	20.2	-1.1	1,408.8

3.3. Enhancement expenditure

Our draft determinations also apply a challenge to the company's proposed enhancement expenditure based on benchmarking models and an assessment of the evidence it has provided. Our approach to enhancement is set out in our our initial assessment of business plans 'Technical Appendix 2: Securing cost efficiency'. Table 3.4 summarises our allowances. The 'South West Water - Cost efficiency draft determination appendix' gives the most significant areas of disallowance, however, our allowance should be considered 'in the round' rather than focus solely on a particular area.

Table 3.4: Enhancement expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Service	Company requested capex	Cost efficiency adjustment	Our allowance
Wholesale water	254.2	-73.5	180.7
Wholesale wastewater	269.9	-17.7	252.2
Total	524.1	-91.2	432.9

3.4. Cost sharing

Our totex allowance is a baseline reference for the application of cost sharing. When a company overruns its totex allowance, the additional cost incurred above the baseline will be shared between its investors and customers. When a company spend less than its totex allowance, it will share the benefits with customers.

Cost sharing rates are the proportion of cost savings that investors get to keep, or the proportion of any cost overrun that investors will have to bear. Cost sharing ensures that customers get a share of the benefits when companies outperform their cost allowance, and that customers and companies are protected when companies overrun their allowance. Cost sharing performance will be taken into account in the PR19 reconciliation for the next price control period.

The cost sharing mechanism applies to total revenue controls only, namely for water resources, water network plus and wastewater network plus. For the water resources and water network plus controls, we set the same cost sharing rates. We do not apply cost sharing in average revenue controls, namely in the retail and bioresources controls. In the average revenue controls, any deviation from our allowed expenditure will be incurred fully by the company.

The sharing rates are determined from the ratio of the company's view of totex to our view of totex. As a fast-track company that accepted the outcome of our view of efficient costs at the initial assessment stage the company's outperformance and underperformance cost saving rates are both 50%.

Table 3.5: Totex cost sharing for cost performance for 2020-25, £ million

	Water resources	Network plus - water	Network plus - wastewater
Cost sharing rate – outperformance	50%	50%	50%
Cost sharing rate – underperformance	50%	50%	50%

Table 3.6 sets out the costs that are subject to cost sharing. Cost sharing will be applied to net totex less third party costs. Net totex excludes grants and contributions and pension deficit recovery cost.

Table 3.6: Totex subject to cost sharing rates – 2020-25, £ million

	Water resources	Network plus – water	Network plus – wastewater
Gross totex (excluding third party costs	78.7	823.6	848.2
Grants and contributions	0.0	36.8	34.7
Net totex (subject to cost sharing)	**78.7**	**786.8**	**813.5**

Note: Table 3.6 does not include third party costs or pension deficit repair expenditure, as these are not included in cost sharing.

3.5. Transition expenditure

Table 3.7 sets out expenditure allowed under the transition programme. The transition programme allows companies to bring forward planned investment from 2020-25 to 2019-20, where it is efficient to do so. Although the expenditure would be incurred in 2019-20, for the purpose of cost performance incentives it is considered as expenditure incurred in the following regulatory period (2020-25).

We allow cost when reasonably justified in order to make efficient use of resources to minimise whole life costs, where it is efficient to bring forward an investment, or to enable companies to meet early statutory deadlines.

Table 3.7: Summary of wholesale water and wastewater requested and allowed transitional capex expenditure 2019-20, (£ million, out-turn nominal).

	Company requested expenditure	Our allowed expenditure	Rationale
Wholesale water	1.3	0.3	We allow the expenditure the company requests relating to the Isles of Scilly. We did not allow that for Knapp Mill as the evidence justifying the proposed solution was insufficient.
Wholesale wastewater	1.6	1.6	We allow the expenditure the company requests relating to the Isle of Scilly and that to enable an early start on WINEP schemes.

3.6. Residential retail

We determine the residential retail control from the expenditure set out in Table 3.8. The table, and the rest of this draft determination, does not include a proportion of our allowed pension deficit recovery costs of £1.2 million in relation to the residential retail control. These costs will be added at final determinations.

Table 3.8 Expenditure, residential retail, 2020-25 (£ million, nominal)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	28.09	28.09	28.09	28.09	28.09	140.44

Note: The residential retail control is an average revenue control. Allowed cost and the associated allowed revenue is based on a forecast of the number of customers.

4. Calculation of allowed revenue

This section sets out the calculation of allowed revenue for each of the price controls, based on our assessment of efficient costs. We set out in section 4.1 the components of allowed revenue for each of the price controls. We then set out information relevant to the calculation of the components of that allowed revenue in sections 4.2 and 4.5.

4.1. Allowed revenue

We calculate revenue separately for each of the wholesale controls and for the residential retail control. We set out the calculation of five year revenues for each of these controls in this section.

Wholesale controls

For the wholesale controls (that is water resources, water network plus, wastewater network plus and bioresources), allowed revenue is calculated based on the following elements, not all elements are applicable to all wholesale controls as set out in Table 4.1.

- Pay as you go (PAYG) – this reflects the allocation of our efficient totex baseline to costs that are recovered from revenue in 2020-25 (PAYG). The proportion of totex not recovered from PAYG is added to the regulatory capital value (RCV) which is recovered over a longer period of time.
- Allowed return on capital – this is calculated based on our assessment of the cost of capital multiplied by the average RCV for each year.
- RCV run-off – this reflects the amount of RCV that is amortised from the RCV in the period of the price control.
- PR14 reconciliations – this reflects the application of out/underperformance incentives or penalties from PR14 through revenue adjustments in 2020-25.
- Fast-track reward – fast-track companies are awarded a financial reward for achieving fast-track status equivalent to 0.1% of return on regulatory equity. Companies are able to decide how they receive this reward either through an adjustment to revenue or to opening RCV.
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the draft determination.
- Income from other sources – this is revenue that companies charge but is not part of the regulated water and wastewater bills that customers pay.

- Grants and contributions – this is an allowance for the income from connection and infrastructure charges.
- Other price control income – this is an allowance for revenue that is included in the price control but is not covered by wholesale charges.
- Revenue re-profiling – this reflects the change in revenue in 2017-18 prices as a result of adjustments made to annual revenues to smooth the final bill profile consistent with customer preferences. The financial model calculates revenue adjustments on a net present value (NPV) neutral basis.

We set out the calculation of the allowed revenue for South West Water's wholesale controls in Table 4.1. We summarise the total of the build up of allowed revenue as five year totals, however our financial model calculates the allowed revenue on an annual basis for the purposes of our draft determination. We state the allowed revenue for each price control on an annual basis in section 5.

We explain how we calculate PAYG, RCV run off and the cost capital in section 4.2, the revenue adjustments for PR14 reconciliations in section 4.3, and other elements of allowed revenue in section 4.4.

Table 4.1: Calculation of allowed revenue (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
Pay as you go	64.6	511.0	437.0	70.8	**1,083.4**
RCV run-off	18.0	330.9	438.1	33.8	**820.8**
Return on capital	19.0	196.3	238.2	10.8	**464.3**
Revenue adjustments for PR14 reconciliations	1.0	-7.6	-4.7	0.0	**-11.3**
Fast-track reward	0.0	1.1	1.3	0.0	**2.4**
Tax	0.7	42.8	46.8	3.3	**93.7**
Grants and contributions (price control)	0.0	34.6	29.9	0.0	**64.5**
Other income (price control)	0.0	20.3	0.0	0.0	**20.3**
Deduct other income (non-price control)	0.0	-21.5	-0.3	0.0	**-21.8**
Revenue re-profiling	0.0	0.7	0.9	0.0	**1.6**
Final allowed revenues	**103.4**	**1,108.7**	**1,187.3**	**118.7**	**2,518.0**

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'South West Water: Allowed revenue appendix' in Tables 1.1 to Table 1.4.

Residential retail control

For the residential retail control, allowed revenue is calculated as:

- retail cost to serve – this reflects our efficient view of costs per customer for the retail business; plus,

- net margin on wholesale and retail activities – this is calculated based on the wholesale revenue applicable to retail customers multiplied by our allowed retail margin. Our methodology set out an early view of the retail margin that applies for the retail price controls, which was used by South West Water in its business plan.

Allowed revenue for the residential retail control is set on a nominal basis and therefore we present the make up of the revenue in the nominal price base in Table 4.2.

Table 4.2: Retail margins (nominal price base)

	2020-25
Total wholesale revenue - nominal (£ million)	2,697.7
Proportion of wholesale revenue allocated to residential (%)	74.31%
Residential retail costs (£ million)	140.4
Total retail costs (£ million)	**2,145.0**
Residential retail net margin (%)	1.00%
Residential retail net margin (£ million)	21.6
Residential retail adjustments (£ million)	-4.4
Residential retail revenue (£ million)	157.7

Note: retail revenue is the sum of the margin, retail costs, and adjustments.

We set out the calculation of residential retail revenue on an annual basis in the ‘South West Water: Allowed revenue appendix’ in Table 1.5.
The proportion of wholesale revenue allocated to residential customers is provided by the company in the business plan tables. We have accepted the company’s view of the allocation of wholesale revenue between residential and business customers.

South West Water based its business plan on the residential retail margin set out in our early view cost of capital. We have set the draft determination on this basis.

4.2. Cost recovery now and in the long term for the wholesale controls

Our totex cost allowances are sufficient to meet a company's operating and capital expenditure. Companies recover this expenditure either in period from current customers using pay-as-you-go (PAYG) or add it to the regulatory capital value (RCV) and recover from future generations of customers using the RCV run-off rates. Consistent with our methodology, we have assessed how each company's choice of PAYG and RCV run off rates reflects the levels of proposed expenditure, bill profiles, affordability and customer views relevant to the short and the long term.

To determine the allowed revenue, the PAYG rate is applied to totex allowance for each wholesale control for each year of the price control. The proportion of the totex allowance that is not recovered in PAYG is added to the RCV and recovered from customers in future periods.

In this section we set out our approach to calculating the PAYG rates, the RCV to which the cost of capital is applied and the RCV run off rates.

PAYG

The average PAYG rates and the associated totex recovery for 2020-25 for each wholesale control is set out in Table 4.3.

To PAYG we add the allowed costs for pension deficit recovery set out in Table 3.2 to derive total amount to be recovered in 2020-25 for each price control.

Table 4.3: PAYG allowances for each wholesale control (5 year)

	Water resources	Water network plus	Wastewater network plus	Bioresources
Totex allowance (£ million)	78.7	811.6	821.4	91.2
Pay as you go totex (£ million)	64.2	502.8	429.6	69.3
Pension deficit recovery cost (£ million)	0.4	8.2	7.5	1.5
Total pay as you go (£ million)	64.6	511.0	437.0	70.8

The PAYG revenue for each year of the price control is based on totex allowance multiplied by PAYG rate for that year plus an allowance for pension deficit recovery costs. The annual PAYG revenue and PAYG rates for each wholesale control are shown in the 'South West Water: Allowed revenue appendix' in tables 2.1 to 2.4.

South West Water's approach to PAYG rates is to recover in each year an amount equivalent to operating costs and similar expenses, plus infrastructure renewal costs. We accept the approach taken by the company and have intervened to amend the PAYG rates proposed in the business plan to reflect our view of the mix of operating and capital expenditure following our totex interventions compared with the business plan. Our view of efficient totex has a lower proportion of capital expenditure than the company's business plan therefore, using South West Water's approach to recovering costs, a higher proportion of totex is recovered in the period through PAYG and less is added to the RCV. We are not intervening on PAYG rates on the basis of financeability.

Table 4.4 sets out the average PAYG rates across 2020-25 for each wholesale control proposed in the company's business plan and for our draft determination.

Table 4.4: PAYG rates for each wholesale control (5 year)

	Water resources	Water network plus	Wastewater network plus	Bioresources
Company plan (%)	74.7%	57.4%	54.4%	71.9%
Draft determination (%)	81.6%	62.0%	52.3%	76.0%

Note: PAYG (%) reflects the weighted average rate applied across the 5 years 2020-25.

Opening RCV adjustments

As part of the business plan South West Water proposed allocations of the RCV for both Water Resources and Bioresources price controls based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale controls and these new controls in accordance with the proportions proposed by South West Water.

We make reconciliation adjustments ("midnight adjustments") related to the company's performance against incentive mechanisms from previous price reviews and for land sales in order to determine the opening RCV for the period of the PR19 controls. We also adjust the RCV upwards to reflect a change in the accounting treatment of leases, which causes some assets formerly recognised as operating leases to be recognised on the company's Balance sheet. In doing so, we have followed the approach set out in IN 18/09 Guidance for reporting operating leases in

PR19 business plans. We have used the adjustment proposed in the company business plan.

Table 4.5: Opening RCV, 1 April 2020 (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources
RCV – 31 March 2020	1,601.3		1,836.1	
% of RCV allocated by control	8.92%	91.08%	95.6%	4.4%
RCV – 31 March 2020	142.8	1,458.5	1,754.8	81.3
Midnight adjustments to RCV	- 8.4	- 74.1	-95.2	0.0
Opening RCV – 1 April 2020 (before fast-track reward)	134.5	1,384.4	1,659.6	81.3

Return on capital

Companies are allowed a return on the RCV, equal to the Weighted Average Cost of Capital (WACC).

Our PR19 methodology set out an ‘early view’ cost of capital for all wholesale controls. South West Water’s business plan incorporates the early view cost of capital for the wholesale price controls of 3.3% - CPIH deflated (2.3% - RPI deflated). We have used the early view cost of capital in this draft determination; we will update our view of the cost of capital when we publish the draft determinations for the slow-track and significant scrutiny companies in July 2019, and again for the final determinations for all companies in December 2019. The fast-track companies will have the opportunity to respond to our updated view of the cost of capital in response to the draft determinations for the slow-track and significant scrutiny companies in July 2019.

The PR19 methodology confirmed we will transition to CPIH as the primary inflation rate from 2020. At 1 April 2020, we will index 50% of RCV to RPI; the rest, including new RCV, will be indexed to CPIH. Table 4.6 and Table 4.7 set out the opening and closing balance for each component of RCV.

The PR19 methodology confirmed our protection of the value of the RCV as at 31 March 2020 across each of the wholesale price controls. New investment that is allocated to the RCV from 1 April 2020 is stated as ‘post 2020 investment’.

In determining the ‘return on capital’ revenue building block, we apply the relevant deflated cost of capital to the average RCV for the year for each component (RPI inflated, CPIH inflated and post 2020 investment) and results in a return on capital for each wholesale control over the period 2015-20 as set out in Table 4.8.

Table 4.6 Opening RCV by wholesale control for each component of RCV, 1 April 2020 (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	67.2	692.2	829.8	40.6	1,629.9
CPIH inflated RCV	67.2	692.2	829.8	40.6	1,629.9
Other adjustments	-	1.2	1.4	-	2.7
Total RCV	134.5	1,385.6	1,661.1	81.3	3,262.4

Table 4.7 Closing RCV by wholesale control for each component of RCV, 31 March 2025 (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	61.9	568.9	664.3	26.3	1,321.4
CPIH inflated RCV	59.2	544.9	640.1	25.1	1,269.3
Post 2020 investment	12.8	276.9	342.6	19.5	651.9
Other adjustments		1.2	1.4		2.7
Total RCV	**133.8**	**1,392.0**	**1,648.5**	**70.9**	**3,245.2**

Table 4.8 Return on capital by wholesale control for each component of RCV, 2020-25 (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	7.4	72.5	85.8	3.8	169.5
CPIH inflated RCV	10.4	101.6	120.6	5.3	238.0
Post 2020 investment	1.2	22.0	31.6	1.7	56.4
Other adjustments	-	0.2	0.2	-	0.4
Total return on capital	**19.0**	**196.3**	**238.2**	**10.8**	**464.3**

Note: Total return on capital is calculated by multiplying the annual average RCV for each element of RCV (RPI inflated, CPIH inflated and post 2020 investment) by the wholesale WACC for each control. The return on capital for each year of the price control for each wholesale control are shown in the 'South West Water: Allowed revenue appendix' in tables 3.1 to 3.16 and 4.1 to 4.4.

RCV run off

RCV run off is the proportion of the RCV which is recovered in the 2020-25 period. Companies are able to propose different run-off rates for RPI inflated and CPIH inflated RCV and also, for the water resources and bioresources controls, for post 1 April 2020 investment. Table 4.9 sets out the resultant RCV run-off revenue for each component of RCV for each wholesale control.

Table 4.9: RCV run off on the RCV (5 year) (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	8.1	147.3	189.7	15.5	360.6
CPIH inflated RCV	8.3	151.7	199.2	15.9	375.1
Post 2020 investment	1.7	31.8	49.3	2.4	85.1
Total RCV run off	18.0	330.9	438.1	33.8	820.8

Note: Total RCV run off is calculated by multiplying the opening RCV by the relevant RCV run off rate for each element of RCV (RPI inflated, CPIH inflated and post 2020 investment) by the RCV run off rate for each control (50% of run off is applied to post 2020 investment in the year of additions).

South West Water's RCV run-off rates are set to recover a value equivalent to the forecast current cost depreciation. We have accepted South West Water's RCV run-off rates for the draft determination. Table 4.9 sets out the average RCV run off rates across 2020-25 for each wholesale control proposed in the company's business plan and for our draft determination.

Table 4.10: RCV run off rates for each wholesale control (5 year)

	Water resources	Water network plus	Wastewater network plus	Bioresources
Original company plan (%)	2.63%	4.69%	5.12%	8.56%
Draft determination (%)	2.63%	4.69%	5.12%	8.56%

Note: RCV run off (%) reflects the average of the rates applied to the CPIH and RPI inflated RCV components across the 5 years 2020-25.

The annual rates for each wholesale control are set out in the 'South West Water: Allowed revenue appendix' in Table 5.1 to Table 5.4.

4.3. PR14 reconciliations

In PR14, we set mechanisms to incentivise companies to do the right thing for their customers. These financial incentives cover cost efficiency, outcomes performance, revenue forecasting (wholesale and retail), customer service (the service incentive mechanism), water trading and land sales. It is important to reconcile the financial impacts of these mechanisms in PR19 to ensure that customers only pay for the service the company delivers.

We are also applying adjustments to reflect performance in the final year of the 2010 to 2015 period, which could not be fully taken into account in PR14. These adjustments apply to the RCV (the “midnight adjustment”) and revenue for the 2020-25 period. These adjustments are made in line with the PR14 reconciliation rulebook.

We are publishing models for each of these reconciliations, and for the overall RCV and revenue adjustments on our website. ‘South West Water - Addressing affordability and vulnerability actions and interventions’ provides a detailed explanation of all policy interventions we are making in the models. Table 4.11 summarises our interventions. Table 4.12 sets out the resulting adjustments to revenue and the RCV. The ‘South West Water - Accounting for past delivery appendix’ sets out how these adjustments are allocated across controls and how the RCV adjustment feeds into the midnight adjustments to RCV set out in Table 4.5.

The reconciliation for the service incentive mechanism is relative and requires information for all companies. We will complete the reconciliation based on latest information. For the slow-track and significant scrutiny companies this information was provided on 1 April 2019. We will publish the reconciliation for all companies alongside draft determinations for slow-track and significant scrutiny companies in July.

For outcome delivery incentives, the information we have used to reflect performance in 2019-20 is based on the company’s latest expectations. Final figures for 2019-20 will not be able to be taken into account in PR19. We set out in the ‘PR14 reconciliation rulebook’ that we planned to complete the reconciliation for 2019-20 outcome delivery incentives at PR24 for 2025-30 so that we could use correct information.

However, most outcome delivery incentives for the 2020-25 period are in period and will have been reconciled before this date. In light of this we consider it would be more appropriate to complete this reconciliation in the autumn of 2021 and apply any change to bills for 2021-22 as part of the new in-period process. We will designate all of the financial PR14 performance commitments as being in-period for this purpose. Any adjustment between the 2019-20 forecast and actual figures should be modest and we would not expect a significant impact on bills. If, contrary to expectations the bill impact was more significant, we would expect companies to take measures to smooth the impact for their customers. The new PR19 mechanism to share unexpected high bill increases in a year will not apply in this case. Instead the PR14 protection that caps the impact across the five years 2015-20 should apply.

The above applies equally to the company's 2015-20 in period outcome delivery incentives and we have used forecast information for 2018-19 and 2019-20 to reconcile these outcome delivery incentives. For the avoidance of doubt, no application is required in 2019 for in period determinations.

Table 4.11: Reconciliation of PR14 incentives, interventions

Incentive	Intervention(s)
Outcome delivery incentives	We are excluding the company's outperformance payment for Service Incentive Mechanism (SIM) of £0.230 million (2012-13 prices net of tax) applied to revenue for end of period outcome delivery incentives for the residential retail price control because the SIM is being reconciled separately from other outcome delivery incentives. We are increasing the underperformance payment for performance commitment W-A5 (Duration of interruptions in supply (hours/property) in 2017-18) by - £0.972 million (2012-13 prices net of tax). We are making this intervention because the company has not reported the service level and resulting outcome delivery incentive for this performance commitment in line with the definition published in the company specific appendix at PR14, as it has excluded restrictions placed on customers for this performance commitment. Our intervention increases the value of the underperformance payment to reflect the exclusions that the company had incorrectly made. The correct duration of interruptions in supply in 2017-18 is 0.544 hours per property.
Residential retail revenue	We are intervening to use the figures from the company's submitted residential retail models for some data lines because we identified unexpected differences between forecasts and actuals in the company's business plan tables. We are intervening to round the company's modification factor figures to 2 decimal places to ensure consistency with the PR14 Reconciliation Rulebook. We are intervening to apply the appointee WACC as the discount rate to be used to provide a financing adjustment for the time value of money of the reward or penalty in line with the PR14 Reconciliation Rulebook.
Wholesale revenue forecasting incentive mechanism	No interventions required.
Totex	We are intervening to ensure the values for 'Water: FD allowed totex inclusive of menu cost exclusions, less pension deficit recovery costs allowance' correspond to the PR14 final determination.

Incentive	Intervention(s)
	We are intervening to ensure the values for 'Wholesale water baseline totex' correspond to the PR14 final determination.
Land sales	We are intervening to revise the calculation of present value effect of 50% of proceeds from disposals of interest in land for the wholesale water and wastewater price controls. We are doing this so that the calculation aligns with the revised business plan table templates released on 31 January 2019.
SIM	See above intervention for outcome delivery incentives.
PR09 blind year adjustments	No interventions required.

Table 4.12: Reconciliation of PR14 incentives, 2020-25 (£ million)

Incentive	RCV adjustments		Revenue adjustments	
	Company view	**Ofwat view**	**Company view**	**Ofwat view**
Outcome delivery incentives	8.2	8.2	11.5	10.4
Residential retail revenue	N/A	N/A	-3.7	-3.7
Wholesale revenue forecasting incentive mechanism	N/A	N/A	-20.0	-19.8
Totex	-161.2	-159.7	-8.4	-8.3
Land sales	-3.5	-3.8	N/A	N/A
Service Incentive Mechanism	N/A	N/A	0.2	N/A
PR09 blind year adjustments	-49.8	-49.8	2.3	2.3
Water trading	N/A	N/A	N/A	N/A
Total	-206.4	-205.0	-18.2	-19.1
Total post profiling	N/A	N/A	-18.9	-20.4

4.4. Other allowed revenue

We also provide companies with a number of other sources of allowed revenue:

- the fast-track reward
- an allowance for tax
- an allowance for income from grants and contributions (which is not included in totex)
- an allowance for other price control forecast income
- deduction of non-price control forecast income

Table 4.13: Calculation of other allowed revenue (£ million)

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
Fast-track reward	0.0	1.1	1.3	0.0	2.4
Tax	0.7	42.8	46.8	3.3	93.7
Grants and contributions (price control)	0.0	34.6	29.9	0.0	64.5
Other income (price control)	0.0	20.3	0.0	0.0	20.3
Deduct other income (non-price control)	0.0	-21.5	-0.3	0.0	-21.8

Fast track reward

We are allowing South West Water a financial reward equivalent to 10 basis points on the return on regulatory equity to recognise the quality of its business plan, as part of it's fast-track status. South West Water requested that this reward is split evenly between the water network plus and wastewater network plus controls and is split between revenue and RCV adjustment in line with the PAYG rate.

Taxation

We calculate a tax allowance reflecting the corporation tax that companies expects to pay during 2020-25. We calculate the tax allowance using the financial model based on the projected taxable profits of the appointed business and the current UK corporation tax rates and associated reliefs and allowances.

South West Water provided information in data tables relevant to the calculation of the expected tax charge. The information has been updated as part of the resubmission of various data tables to take account of the recent UK corporation tax legislation. We have accepted the information provided by the company and applied this to the draft determination.

Our interventions in other areas may impact on forecast levels of capital expenditure and in the area of new connections our assumed recovery rates may differ from what South West Water had assumed in the business plan. The resulting impact on allowances used for the calculation of taxation has not been reflected. Where these changes result in significantly different inputs for capital allowances or tax deductions, we expect South West Water to identify this as part of its representations on the draft determination.

Grants and contributions (price control)

Companies receive grants and contributions from developers towards the costs of ‘new developments’, expenditure to reinforce the network, and ‘new connections’, expenditure to connect a property, for example the meter and connection pipe. We calculate the grants and contributions by applying a recovery rate to our view of new developments and new connections expenditure. This ensures that developers pay a fair share towards costs to connect new properties rather than these costs being borne by customers in general. We provide companies with an allowance equal to the income that we expect companies to be able to recover from developers.

We use industry wide recovery rates for water and wastewater new developments and new connections.

- For water new developments we use a rate of 66% derived from industry data; and
- For water new connections and wastewater new developments we use a rate of 100% based on our understanding of historical practice in the industry and is broadly supported by company business plans.

Both of these rates are slightly lower than the South West Water business plan. Our view of new developments and new connections expenditure is also lower than South West Water’s forecast. In combination this gives a lower view of grants and contributions than the company forecast.

For diversions activities, where companies move their assets to make way for new infrastructure, we have used the company view of the associated income.

Other price control income

Other price control income covers income from the sale of non-potable water (not covered by bulk supplies) and rechargeable works. We include an allowance equal to the income that we expect companies to recover from other price control income. We have reviewed the company forecast of 'other price control income' and use this in the draft determination.

Non-price control income

Non-price control income is income from the excluded charges defined in licence condition B. It includes bulk supplies, standpipes and unmeasured cattle troughs. This is deducted from the total allowed revenues

We have reviewed the company forecast of 'non-price control income' and use this in the draft determination.

Uncertainty mechanisms

The PR19 methodology makes limited provision for companies to propose bespoke uncertainty mechanisms. South West Water has not proposed any uncertainty mechanisms in its business plan.

5. Returns, financeability and affordability

This section sets out company proposals for aligning the interests of company management and investors with its customers. We set out South West Water's proposals in response to our 'Putting the sector in balance' position statement. We comment on the expected range of returns for the notional financial structure. We comment also on the financeability and affordability of the draft determination and any adjustments that we have made to the bill profile.

5.1. Putting the sector in balance

In July 2018 we published our 'Putting the sector in balance' position statement. The position statement set out the steps we expect companies to take to demonstrate they strike the right balance between the interests of customers and their investors. We expect that:

- company dividend and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers;
- companies with high levels of gearing will share financing gains from high gearing with customers; and
- companies will provide assurance that they are financially resilient.

We also encouraged companies to adopt voluntary sharing mechanisms, particularly where, for example, companies outperform our cost of debt assumptions.

Our assessment of South West Water's proposals is in Table 5.1.

Table 5.1: Our assessment of South West Water's proposals to balance the interests of customers

Issue	Our assessment
Gearing outperformance benefit sharing	South West Water projects gearing will remain below 70% in 2020-25. However, the company has provided a clear statement that it is committed to implementing the default gearing benefit mechanism should gearing exceed 70% in 2020-25.
Voluntary sharing mechanisms	South West Water has committed to sharing a proportion of its outperformance on the embedded cost of debt. The company estimates that this should result in sharing payments of around £20 million in 2020-25. An independent customer panel elected by customers will review and challenge the company's recommendations on how benefits should be shared with customers. It has also committed to funding of hardship schemes.

Issue	Our assessment
Dividend policy for 2020-25	South West Water has committed to the proposals on dividend policy as set out in our putting the sector in balance position statement. In doing so it has indicated a base dividend yield of 4.4% for 2020-25. It has confirmed that when setting dividend payments, the company's Board will consider if the company has delivered on its commitments to customers. The company has committed to reporting on its dividend policy annually, that the published information is clear and transparent and that it links to performance delivery for customers. It has also committed to signal changes to stakeholders. However no detail has been provided on which obligations or commitments to customers will be considered or how they will affect dividend payments. We expect the company to be transparent in this area, to demonstrate that in paying or declaring dividends that it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination.
Performance related executive pay policy for 2020-25	South West Water has stated it is committed to meet the expectations set out in our 'putting the sector in balance' position statement. South West Water has confirmed that its Remuneration Committee has discussed and approved the following policy: • The annual bonus will be based on (i) 70% weighting linked to specific customer delivery targets, underpinned by an expectation that performance related pay will be made only if at least 90% of a basket of ODIs to customers are met, (ii) 10% weighting to personal objectives, including delivery of the 'New Deal', and (iii) 20% weighting linked to financial delivery targets that support financial sustainability (10% Profit before tax and 10% net debt / gearing). • The long term incentive will apply equal weighting to (i) RoRE outperformance (based on the Final Determination), (ii) sustainable dividend measures and (iii) C-Mex. An underpin applies which will allow the Remuneration Committee to reduce or withhold vesting if it is not satisfied with the underlying operational and economic performance of the company. Malus and clawback arrangements will also be in place. • The South West Water Remuneration Committee will oversee in the first instance the monitoring and application of its Executive Pay policy, with the potential from 2020 of the Independent Customer Challenge Panel having role in monitoring the policy. • In addition to reporting through the annual report and accounts, information will be disseminated to the Customer Challenge Panel, through a customer oriented document. The policy, as set out above, demonstrates the company's commitment to move in the direction of the expectations set out in 'Putting the sector in balance'. We understand that there remain a number of details to be finalised, for example how targets are to be set. We expect the company and its remuneration committee to ensure executives continue to have stretching targets linked to performance delivery for customers, and that any further updates to the policy for 2020-25 are transparently reported to stakeholders.

Issue	Our assessment
Financial resilience	South West Water's board has provided assurance that, in all of the financial risk scenarios considered, mitigation measures mean that the company's business plan is financeable. This view is supported by its stress testing of key financial ratios for the period to 2025. South West Water expects its gearing to remain close to our notional level of 60% for 2020-25 and, in response to our challenge, the company has committed to assess its financial resilience beyond 2025 in its next long term viability statement.

5.2. Return on regulatory equity

The PR19 methodology set out that we expected companies to demonstrate a clear understanding of risk to the delivery of their business plans and to explain and demonstrate how they manage and mitigate risk. We expected companies to use Return on Regulatory Equity (RoRE) analysis to assess the impact of upside and downside risk on the basis of their notional capital structures based on a prescribed suite of scenarios using P90/P10 confidence limit values[2].

RoRE is calculated as the return on equity for the equity portion of the RCV based on our notional gearing assumption. A company's base RoRE is aligned with our assumed real post-tax cost of equity, but can differ between companies because the blended real cost of equity will vary according to the proportion of the RCV (and notional regulatory equity) that is indexed to RPI or CPIH. The proportion of RCV (and notional regulatory equity) that is linked to RPI or CPIH will vary between companies according to factors that include the size of the investment programme, the proportion of totex that is capitalised and RCV run-off rates.

We did not require South West Water to carry out any additional actions on its RoRE risk analysis for our fast-track determination. However, it reassessed risk range values for ODIs as a result of our required actions. Table 5.2 sets out the annual average RoRE ranges in South West Water's PR19 business plan submission, and the values in our determination. The RoRE ranges for South West Water are illustrated in Figure 5.1. The base RoRE in our draft determination reflects the reward for fast-track status. This is calculated at 10 basis points on regulated equity. South West Water requested that this reward is allocated between the water network plus and wastewater network plus controls based on opening RCV and that it is split between revenue and RCV adjustment in line with the average PAYG rate.

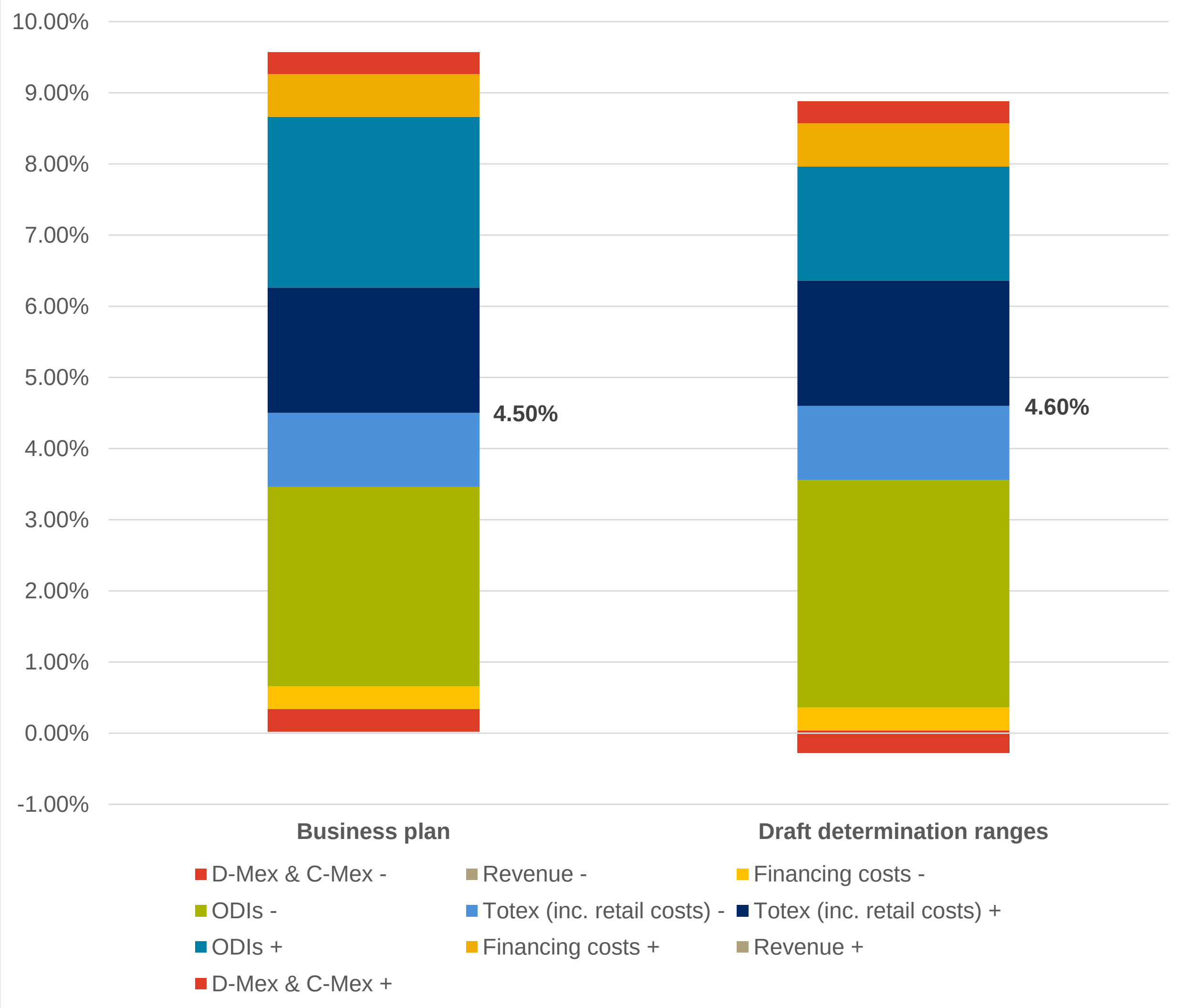
[2] Values that the company considers would not be exceed 90% of the time.

Table 5.2: Annual average RoRE risk ranges

	Business plan		Draft determination ranges	
Base RoRE	4.50		4.60[1]	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-0.99	1.75	-0.99	1.75
ODIs	-2.80	2.40	-3.20	1.60
Financing costs	-0.32	0.60	-0.32	0.61
Retail costs	-0.05	0.01	-0.05	0.01
D-Mex & C-Mex	-0.32	0.31	-0.32	0.31
Revenues	0.00	0.00	0.00	0.00
Total	-4.48	5.07	-4.88	4.28

[1] The base RoRE in the draft determination takes account of the 10 basis point uplift for fast-track status and the effect of reconciliations for past delivery. We are reviewing this and may amend the approach for the slow-track draft determinations and final determinations for all companies.

Figure 5.1: RoRE ranges



The draft determination risk ranges shown in Table 5.2 and Figure 5.1 reflect our interventions. In particular, we have included the RoRE risk ranges for ODIs that are shown in Table 2.3 in section 2. The values for ODIs represent the upper and lower extreme levels of performance.

We expect that the company will provide an updated view of RoRE risk ranges at P10/P90 confidence levels in light of our draft determination[3]. For this purpose, the company should apply its view on the interactions between individual ODI risks in arriving at an overall risk range for ODIs.

[3] Calculated using the App26 rows on the F-Inputs tab of the draft determination financial model.

5.3. Financeability

We interpret our financing duty as a duty to secure that an efficient company can finance its functions, in particular by securing reasonable returns on its capital. In coming to our determinations we assess whether allowed revenues, relative to efficient costs, are sufficient for an efficient company to finance its investment on reasonable terms and to deliver activities in the long term, while protecting the interests of current and future customers.

Our final methodology required companies to provide Board assurance that the business plan was financeable on both the notional and their actual capital structures. Companies were required to provide evidence to support these statements, including evidence supporting the target credit rating and that this was supported by the financial ratios that underpin the plan. In our initial assessment of business plans, we assessed there was sufficient evidence to support the South West Water's Board assurance statement that the business plan is financeable.

We consider that companies and their shareholders should bear the risk of their capital structure and financing choices, not customers. Therefore, we have focused on whether our draft determination is financeable based on the notional capital structure that underpins our cost of capital using our own financial model. Our assessment uses a suite of financial metrics based on those used in the financial markets and by the credit rating agencies. Based on the financial ratios from the financial model alongside evidence in the business plan, we consider that South West Water's draft determination is financeable for the notional structure.

The results for key financial ratios is set out below. Key financial ratios for the notional company structure in our draft determination are slightly improved compared to the ratios set out by South West Water in its business plan. This is a result of the assessment of costs, which reduces average gearing and the requirement for debt, and a resulting improvement in the cash interest and FFO/debt ratios.

Table 5.3: Financial ratios – notional structure before reconciliation adjustments (5 year average)

	Business plan	Draft determinations
Gearing	61.01%	57.88%
Interest cover	4.36	4.73
Adjusted cash interest cover ratio (ACICR)	1.82	2.00
Funds from operations (FFO)/Net debt	10.92%	11.93%
Dividend cover	1.52	2.16
Retained cash flow (RCF)/Net debt	7.60%	9.54%
Return on capital employed (RoCE)	5.29%	5.37%

The basis of the calculation of the ratios is set out in the PR19 methodology
Net debt represents borrowings less cash and excludes any pension deficit liabilities.
FFO is cash flow from operational activities and excludes movements in working capital.
Cash interest excludes the indexation of index-linked debt.

As set out in section 4 we have amended PAYG rates to reflect our view of efficient total expenditure and therefore the mix of operating and capital expenditure. We have not amended RCV run off rates. The reduction in expenditure means that the RCV will now decline slightly rather than increase.

Table 5.4: PAYG rates, RCV run off and RCV growth

	PAYG	RCV run off	RCV growth
Company plan	57.6%	4.9%	0.4%
Draft determinations	59.1%	4.9%	-0.5%

5.4. Affordability and bill profile

South West Water separately tested bill profiles for the South West Water and Bournemouth areas. For the South West Water area the company tested reducing bills from £491 to £441 in real terms (or to £504 in nominal terms). 88% of customers found the real bill reduction to be acceptable. For the Bournemouth area the company tested reducing bills from £140 to £133 in real terms (or £152 in nominal terms). 92% of customers found the real bill reduction to be acceptable. However, the profiles tested were higher than those in the business plan and those resulting from our draft determinations.

In its business plan the company states that it tested different bill profiles to 2024-25 with their customers. The company states that customers said reductions in bills should be passed on as quickly as possible but only if price rises remain steady thereafter. The bill profile put forward in the company's business plan provides an immediate reduction at the start of the period, followed by flat nominal bills. South West Water's CCG is satisfied that affordability considerations have been effectively integrated into customer engagement, stating that the company 'has understood customer views with regards to bill volatility in the development of the WaterShare+ mechanism in order to protect customers from volatility'.

South West Water's bill profile in its original business plan put forward a 14% bill cut for the 2020 to 2025 period, our amended profile increases this reduction to 15%. The table below sets out the difference in bill profile between the company's business plan submission in September 2018 and our amended draft determination profile. We have made one minor amendment to the profile to smooth out a small increase in nominal bills in 2021-22.

Table 5.5: Bills in real terms

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan	£527	£489	£483	£472	£464	£454
Bill profile – before re-profiling	£527	£488	£483	£466	£458	£448
Draft determinations	£527	£489	£478	£468	£458	£450

In its business plan, the company sets out its intention to further reduce bills by 12.5% in the 2025-30 period. The company engaged with customers on long-term investments and inflation, and outlined its long-term investment options until 2050.

Table 5.6: Long term bills

	2020-25	2025-30
Company view of plan	£473	£410

5.5. Help for customers who are struggling to pay

Our draft determinations for South West Water will cut average bills by 15% in real terms between 2020 and 2025.

In addition, South West Water commits to:

- double the number of customers on support tariffs from 25,000 at the end of the current regulatory period to 50,000 by 2024-25;
- increase its social tariff cross-subsidy from £2 to £9 per customer and jointly fund an extension to its WaterCare 'social' tariff;
- continue income maximisation checks to support customers in identifying unclaimed benefits and states this will bring up household income for beneficiaries by an average of £43 per week; and
- Provide dual billing for all unmetered customers to help customers understand if they would benefit from moving to a water meter.

  South West Water has three performance commitments on affordability, which will require it to:

- improve customer views of value for money;
- increase the number of customers receiving social tariffs; and
- reduce the number of customers in water poverty.

Companies will be reporting their performance against the PSR common PC and their bespoke affordability and vulnerability PCs to us and their customers on an annual basis during the price control period. In addition, companies put forward in their business plans further measures for addressing affordability and vulnerability issues. We expect companies to report periodically to their customers on their progress on addressing affordability and vulnerability concerns. We will also be considering how we will scrutinise and report on companies' progress in this important area, including working with other stakeholders in the water sector and beyond.

5.6. Total revenue allowances and k factors

Table 5.7 summarises the allowed revenue for each control. This is expressed in a 2017-18 CPIH price base so that this can be compared with the rest of this document.

Table 5.7: Allowed revenue by year (£ million, 2017-18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water resources	21.1	20.4	20.9	20.5	20.4	**103.4**
Water network plus	224.4	223.5	222.4	219.5	218.9	**1,108.7**
Wastewater network plus	242.1	240.6	237.1	235.4	232.1	**1,187.3**
Bioresources	25.1	24.4	23.4	23.0	22.7	**118.7**
Residential retail	28.9	28.8	28.5	28.2	27.8	**142.2**
Total	**541.6**	**537.8**	**532.2**	**526.6**	**522.0**	**2,660.2**

The water resources, water network plus and wastewater network plus controls are in the form of a percentage limit (inflation plus or minus a number that we determine for each year of the control (the ‘K’ factor)) on the change in allowed revenue (R) from the previous charging year (t-1). This is based broadly on the formula:

$$R_t = R_{t-1} \times \left[1 + \frac{CPIH_t + K_t}{100}\right]$$

Table 5.8 sets out the K factors in each year for each of these three controls. For the first year, we have set a ‘base’ revenue which will be used as the starting revenue for calculating 2020-21 allowed revenues.

Table 5.8: Base Revenue and K factors by charging year (2017-18 prices)

	Base (£ million)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	21.1	0.0	-3.25%	2.21%	-1.57%	-0.48%
Water network plus	224.4	0.0	-0.37%	-0.54%	-1.37%	-0.27%
Wastewater network plus	242.1	0.0	-0.57%	-1.55%	-0.76%	-1.39%

In addition to these controls, we have set a modified average revenue control for bioresources. We recognise that a proportion of bioresources revenues are fixed, so it would be inappropriate to set an average revenue control which did not account for this. The revenue control ensures that where sludge production varies the incremental change in revenues that arises is aligned to incremental costs. Therefore, the 'modified average revenue' control includes a revenue adjustment factor, which applies if there are differences between the forecast and measured quantities of sludge.

Getting the alignment between incremental revenues and incremental costs right is key to ensuring that the company is correctly remunerated, if there is a difference between the sludge companies actually produce and what they had forecast. To ensure companies' allowed revenues reflect their costs, we are intervening to implement a standard approach across companies to this classification. We have set out our methodology and our reasons for intervening in the appendix 'Our methodology for the classification of bioresources costs'. Further details of how we have applied the methodology to South West Water is set out in the 'Bioresources revenue to remunerate fixed costs - South West Water' model.

Table 5.9 sets out our view of the share of revenue to remunerate fixed costs.

Table 5.9: Classification of proportion of revenue to remunerate fixed costs for bioresources

Bioresources revenue requirements to remunerate fixed costs in £ million 2017-18 FYA CPIH deflated prices (2020-2025)	Company view	Ofwat view based on company submitted data	Ofwat view based on draft determination
Total return on capital	N/A	11.3	10.8
Total run off	N/A	34.5	33.8
Revenue to service RCV	**N/A**	**45.8**	**44.6**
Local authority and Cumulo rates for both treatment and disposal	N/A	3.7	3.7
Fixed share of other direct costs of treatment and disposal	N/A	6.3	6.0
Fixed share of other indirect cost of treatment and disposal	N/A	2.9	2.8
Fixed PAYG revenue	**N/A**	**13.0**	**12.6**
Fixed share of revenue to cover tax	N/A	0.0	0.0
Pension deficit repair contributions	N/A	1.6	1.5
Other fixed costs	**N/A**	**1.6**	**1.5**
Revenue to remunerate fixed costs	**52.5**	**60.4**	**58.6**

The modified average revenue in each year is calculated by a formula that we set out in the 'Notification of the PR19 draft determination of Price Controls for South West Water Limited', which includes some components set now in this determination and some components which relate to out-turn performance (such as the actual volume of sludge in future years).

Table 5.10: Bioresources control

	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
Bioresources – total revenue (£ million)	25.1	24.4	23.4	23.0	22.7	**118.7**
Forecast volume of sludge (TDS)	42,100	42,400	42,700	43,000	43,400	**213,600**
Revenue to remunerate fixed costs (£ million)						**58.6**
Baseline average revenue per unit of sludge (£/TDS)						**555.7**

Note: baseline average revenue per unit of sludge assumes that the out-turn volume of sludge will be the same as the forecast.

6. Next steps

The procedural benefit of an early draft determination for fast-track companies is strengthened by early certainty on specified components of the draft determination related to outcomes and the cost allowance. These components are in the PR19 methodology and set out in Figure 6.1. South West Water has chosen to opt in to the early certainty principle entirely.

Early certainty does not apply to other components, including the cost of capital and retail margins. This allows us to make sure these are set at the efficient level for all companies in the final determinations.

Figure 6.1 Early certainty principle

We will not change our draft determination decision related to the company's own cost claims.

We will not change bespoke performance commitment levels.

We will not change financial incentives on performance commitments[4].

We will not change the number of financial ODIs.

We will not change the design of financial incentives in terms of deadbands, caps and collars. (Deadbands are levels of performance that do not lead to outperformance or underperformance payments. Caps and collars are limits on the maximum exposure by companies for their performance on one particular measure.)

We will publish South West Water's final determination in December 2019 after considering representations on the draft determination and other relevant matters. Except where the early certainty principle applies the final determination may be different to the draft determination.

[4] However, to protect customers, the early certainty principle will not apply if a company's outperformance payment or underperformance penalty rate was the highest or lowest, respectively, of all the companies. This is to protect customers against a company that has proposed ODI rates that are outliers compared to other companies.

Table 6.1: Timelines and next steps for all companies

Company category	Next steps	Date
Fast track companies	Fast-track companies' representations on draft determinations	10am on 24 May 2019
Slow track companies	Slow-track and significant-scrutiny draft determinations to be published	7am on 18 July 2019
	Slow-track and significant-scrutiny companies' representations on draft determinations	10am on 30 August 2019
All companies	Companies resubmit 2014 price review reconciliations to include 2018-19 actual data and updated forecasts for 2019-20	15 July 2019
	Final determinations to be published	7am on 11 December 2019

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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