

April 2019

Trust in water

# **Notification of the PR19 draft determination of price controls for Severn Trent Water**

**0 f w a t**

[www.ofwat.gov.uk](http://www.ofwat.gov.uk)

# 1. Notification of the draft determination of price controls for Severn Trent Water Limited

## 1.1 About this document

Every five years we set the price, service and incentive package for monopoly water companies. This document sets out for consultation the draft determination of the formal price controls for Severn Trent Water Limited (**Severn Trent Water**) which will apply over the 2020 to 2025 period.

This first section provides an introduction to how the price controls will operate. The rest of the document is structured as follows:

- our proposed approach to the designation of activities to be included in the water resources, bioresources and retail controls;
- the draft price controls for water network plus activities and wastewater network plus activities;
- the draft price control for water resources activities;
- the draft price control for bioresources activities;
- the draft price control for residential retail activities;
- the proposed assumptions on notified items and land sales;
- the proposed performance commitments that could lead to changes in the price controls during the 2020 to 2025 period to reflect the water company's performance; and
- the proposed revenue forecasting incentive (RFI) formula that we intend to apply, subject to a forthcoming licence modification consultation.

This document has been published on our website. We are also publishing information on our general approach and the reasons for our draft decisions. For all other documents related to the Severn Trent Water draft determination, please see the [draft determinations webpage](#).

## 1.2 Background

The 2019 price review (PR19) will set out the price, service and incentive package that will apply to monopoly water companies for the 2020 to 2025 period. In the PR19 methodology we consulted on our approach to setting price controls, building on the work that we had undertaken as part of the Water2020 programme. Our approach to setting price controls as part of the PR19 reflects a number of changes from the approach taken at the 2014 price review (PR14). These include:

- determining separate wholesale controls for water resources, network plus water, network plus wastewater and bioresources activities;
- the change in the measure of inflation used to index controls, replacing the retail price index (RPI) with the consumer price index including owner occupiers' housing costs (CPIH);
- a move to more in-period rather than end of period outcome delivery incentives (ODIs); and
- replacing the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) with the RFI.

We summarise our general approach to the key elements below.

### **1.2.1 Designation of activities**

We need to designate the activities that are included in the new water resources and bioresources price controls. Our designation of activities follows the approach we set out in the PR19 Methodology. Where appropriate, we cross-refer to updated definitions in our Regulatory Accounting Guidelines (RAGs) that we provide to companies.

We are not proposing any change to the designation of retail activities. The definition of these activities would therefore remain the same as it was for PR14.

### **1.2.2 Form of control**

In our PR19 methodology we set out the form that each control would take. In the formal price controls below we have included in-period adjustments<sup>1</sup> which would apply automatically. We have excluded in-period adjustment made through in-period determinations i.e. in-period ODIs.

Below, we set out the some of the specific considerations for each control.

**Network plus activities:** For network plus activities the form of control is determined in licence condition B (Charges). Allowed revenue changes each year in line with inflation, CPIH, and a factor we determine, 'K'. Due to the constraints of the

---

<sup>1</sup> End-of-period adjustments are not included because, by definition, allowed revenues would be adjusted at the end of the price control period.

condition, further potential adjustments to the level of these controls (e.g. to accommodate the RFI and blind year adjustments) are addressed separately.

**Water resources:** We have structured the control in the same way as for network plus activities. In our PR19 methodology we set out the adjustment mechanism for changes to water companies' allowed revenue once the bilateral market opens. Adjustments will be based on the difference between forecast and actual bilateral market entry, but will only be made if a company invests in new water resource capacity after 1 April 2020. For Severn Trent Water we have not included this adjustment mechanism as there is no relevant new water resources capacity.

**Bioresources:** This is an average revenue control, with allowed revenue adjusted to reflect the difference between forecast and actual sludge volumes based on the variable cost of sludge. There is also a revenue adjustment mechanism to account for any imbalance between allowed revenues and revenues actually recovered – this is applied with a two year lag due to reporting reasons.

**Residential retail:** The residential retail control is an average revenue control. Allowed revenue is adjusted to reflect the difference between actual and forecast customer numbers. Our control does not distinguish between classes of customer, reflecting our assessment of companies' costs.

**Revenue forecasting incentive:** In our PR19 methodology document we said that we would introduce the RFI to apply a revenue correction adjustment and a financial incentive to each charging year's recovered revenue for the network plus activities and water resources controls. The draft RFI formula is set out in Appendix 2. We will propose a licence modification later this year to make sure that such in-period adjustments are allowed during the 2020 to 2025 period and future price control periods. This will be equivalent to the licence modification we made for most companies in 2016 to implement the WRFIM in the current price control period.

### 1.2.3 Outcomes

We can change the level of price controls during the 2020 to 2025 period to reflect performance commitments, provided those performance commitments are notified to the company by 31 December 2019.

The PR19 methodology encourages companies to make more of their performance commitments subject to in-period assessment of ODIs rather than end-of-period. In Appendix 2 we set out for consultation the company's performance commitments which have in-period financial ODIs along with the price controls to which they apply.

In relation to common performance commitments with financial ODIs, companies have put forward a variety of proposed allocations across price controls. We accept that there may be good reasons for these differences and at this stage we have accepted the proposed allocations. We will consider further whether this is an appropriate approach for slow track and significant scrutiny draft determinations in July and for final determinations for all companies in December.

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 the initial assessment of business plans [Technical appendix 1: Delivering outcomes for customers \(January 2019\)](#) 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 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 Return on Regulatory Equity (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 (including how it will affect the in-period assessment of ODIs) as part of the final determinations in December 2019.

As well as the performance commitments set out in Appendix 2, we also propose to include in our final notification the company's existing performance commitments that cover 2019-20 and have financial ODIs. This will allow us to adjust price controls during the 2020 to 2025 period (instead of waiting until the 2024 price review) to reflect any differences between the assumptions about 2019-20 performance we use when setting the 2020 to 2025 price controls and actual 2019-20 performance. We are not publishing these performance commitments at the draft determination stage because these are already known and will not be changing. Because any such adjustments would relate to performance in the current (2015 to 2020) price control period, they will not be covered by the above mechanism to protect customers from higher than expected outperformance payments in relation to the 2020 to 2025 period.

## **2. Notification by the Water Services Regulation Authority of the draft determination of Price Controls for Severn Trent Water Limited**

This document sets out for consultation the draft determination by the Water Services Regulation Authority (“Ofwat”) of the Price Controls for Retail Activities, Network Plus Water Activities, Network Plus Wastewater Activities, Water Resources Activities and Bioresources Activities.

The final determination of the Price Controls will be made by Ofwat in December 2019 in accordance with Part III of Condition B (Charges) of your Appointment as a water and sewerage undertaker:

- after having had regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to Ofwat’s determinations, including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur; and
- in accordance with the statement setting out strategic priorities and objectives for Ofwat published by the Secretary of State for Environment, Food and Rural Affairs.

The Price Controls, when they take effect, will all apply for the five consecutive Charging Years starting on 1 April 2020.

Unless the contrary intention appears, words and expressions used in this document shall have the same meaning as in the Conditions of the Appointment. Common terms used in the formulae in this document are defined in the Glossary set out in Appendix 4.

### **2.1 Designation of activities**

The sets of activities that Ofwat proposes will be covered by the relevant Price Controls are set out below.

### **2.1.1 Network Plus Activities**

All activities carried out by the Appointee in performance of its functions as a water undertaker that are not designated as Water Resources Activities or Retail Activities will be Network Plus Water Activities.

All activities carried out by the Appointee in performance of its functions as a sewerage undertaker that are not designated as Bioresources Activities or Retail Activities will be Network Plus Wastewater Activities.

### **2.1.2 Water Resources Activities**

Ofwat proposes to designate as Water Resources Activities under sub-paragraph 9.9 of Condition B the activities carried out as part of the Appointed Business that fall within the definitions of the following services in [RAG 4.08 – Guideline for the table definitions in the annual performance report](#) (March 2019)<sup>2</sup>:

- Water resources – Abstraction licences; and
- Water resources – Raw water abstraction.

### **2.1.3 Bioresources Activities**

Ofwat proposes to designate as Bioresources Activities under sub-paragraph 9.9 of Condition B the activities carried out as part of the Appointed Business that fall within the definitions of the following services in [RAG 4.08 – Guideline for the table definitions in the annual performance report](#) (March 2019)<sup>3</sup>:

- Sludge transport;
- Sludge treatment; and
- Sludge disposal.

---

<sup>2</sup> Condition B sets the envelope of what activities can be designated as Water Resources Activities by reference to RAG 4.06, but Ofwat intends to actually designate Water Resources Activities in December 2019 by reference to the most recent version.

<sup>3</sup> Condition B sets the envelope of what activities can be designated as Bioresources Activities by reference to RAG 4.06, but Ofwat intends to actually designate Bioresources Activities in December 2019 by reference to the most recent version.

## 2.1.4 Retail Activities

Ofwat does not propose to change the activities that are currently designated as Retail Activities.

## 2.1.5 Wholesale activities not covered by wholesale price controls

The Price Controls in respect of Water Resources Activities, Bioresources Activities, Network Plus Water Activities and Network Plus Wastewater Activities will not apply to those activities for which there are Excluded Charges. Excluded Charges (as defined in Condition B) include:

- charges for a supply of water in bulk to another water undertaker;
- amounts payable in respect of an unmeasured supply of water by means of stand-pipes or water tanks and in respect of the erection or maintenance of stand-pipes or water tanks;
- charges for a supply of water provided by the Appointee under section 59 (Supplies for other public purposes) of the Water Industry Act 1991;
- charges for the reception and disposal by the Appointee, or other person specified by the Appointee or, as the case may be, the Water Authority, of matter delivered to the Appointee or such other person by a collection authority in pursuance of section 14(9) of the Control of Pollution Act 1974;
- charges for unmeasured supplies of water to cattle troughs;
- charges for unmeasured building water supplies;
- amounts payable in respect of an unmeasured supply of water by means of bowsers or water tankers;
- charges for unmeasured supplies of water to farm taps and other agricultural water points; and
- amounts payable under any such agreement as is described in section 20(1)(b) of the Water Resources Act 1991 (including any such agreement entered into by the Water Authority under section 81 of the Water Resources Act 1963 with respect to any of the matters referred to in sections 81(1)(b) and 81(1)(d) of that Act as, by virtue of paragraph 29(1) of Schedule 26, has effect on and after the transfer date as a thing done by the Appointee); and
- charges payable under any agreement for any unmeasured supply of water or unmeasured sewerage services which are calculated by reference to the rateable value of hereditaments, occupied by the person to whom the supply or services are provided, fixed in accordance with section 32, 33 or, as the case may be, 34 of the General Rate Act 1967 or, as the case may be, fixed in accordance with section 54 of the Local Government Finance Act 1988.



## 2.2 Price Controls for Network Plus Activities

In respect of the Appointed Business's Network Plus Activities, except those activities for which there are Excluded Charges, there will be:

- one single Price Control in respect of the Appointed Business's Network Plus Water Activities; and
- one single Price Control in respect of the Appointed Business's Network Plus Wastewater Activities.

Each such Price Control will consist of in each Charging Year:

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

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

For each Charging Year starting on or after 1 April 2021 the revenue allowed to the Appointed Business in respect of the Network Plus Activities concerned will be the product of the following formula:

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

For the Charging Year starting on 1 April 2020 the revenue allowed to the Appointed Business in respect of the Network Plus Activities concerned is the product of the same formula except that  $R_{t-1}$  = the relevant revenue allowance (as set out below). This is because (as the form of Price Controls has since changed) at the last Periodic Review no revenue allowance in respect of Network Plus Activities was set for the Charging Year that started on 1 April 2019.

In respect of the Appointed Business's Network Plus Water Activities, 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 2020 (the revenue allowance for Network Plus Water Activities) is **£671.550** million, which shall constitute the value of  $R_{t-1}$  in respect of that Charging Year.

The “K” numbers for each Charging Year are set out in Table 1.

**Table 1: Price Control for Network Plus Water Activities “K” numbers**

Charging Year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25
K number	0.00	0.37	-1.67	0.52	1.97

In respect of the Appointed Business’s Network Plus Wastewater Activities, 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 2020 (the revenue allowance for Network Plus Wastewater Activities) is **£702.586** million, which shall constitute the value of **R<sub>t-1</sub>** in respect of that Charging Year.

The “K” numbers for each Charging Year are set out in Table 2.

**Table 2: Price Control for Network Plus Wastewater Activities “K” numbers**

Charging Year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25
K number	0.00	-1.29	-0.32	0.91	2.29

## 2.3 Price Control for Water Resources Activities

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

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

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

For each Charging Year starting on or after 1 April 2021 the revenue allowed to the Appointed Business in respect of the Water Resources Activities concerned will be the product of the following formula:

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

For the Charging Year starting on 1 April 2020 the revenue allowed to the Appointed Business in respect of Water Resources Activities is the product of the same formula except that  $R_{t-1}$  = the relevant revenue allowance (as set out below). This is because (as the form of Price Controls has since changed) at the last Periodic Review no revenue allowance in respect of Water Resources Activities was set for the Charging Year that started on 1 April 2019.

In respect of the Appointed Business’s Water Resources Activities, 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 2020 (the revenue allowance for Water Resources Activities) is **£78.271** million, which shall constitute the value of  $R_{t-1}$  in respect of that Charging Year.

The “**K**” numbers for each Charging Year are set out in Table 3.

**Table 3: Price Control for Water Resources Activities “K” numbers**

Charging Year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25
K number	0.00	3.55	0.48	2.28	4.88

## 2.4 Price Control for Bioresources Activities

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

- an average amount of revenue per unit of sludge produced<sup>4</sup> – this is modified to reflect the revenue allowance to ensure there is no over- or under-recovery of fixed costs if outturn sludge production differs from the forecast level. This ensures incremental revenues align with incremental costs;
- the number of units of tonnes of dried solids sludge produced;
- an adjustment to reflect any over- or under-recovery of revenue in previous Charging Years; and

<sup>4</sup> Our bioresources volume measure is defined here: <https://www.ofwat.gov.uk/wp-content/uploads/2017/04/Wholesale-market-readiness-IN.pdf>

- an adjustment to reflect any profit made by the Appointed Business where assets belonging to the Appointed Business are used by any other person (or by any business or activity of the Appointee other than the Appointed Business)

and shall limit the change in the revenue allowed to the Appointed Business in each Charging Year starting on or after 1 April 2020. The Price Control shall be calculated by the following formula:

$$R_t = (MAR_t \times ATDS_t) - ABR_t - [T_{t-2} \times (1 + \frac{CPIH_{t-1}}{100}) \times (1 + \frac{CPIH_t}{100})]$$

Where:

$$MAR_t = \left[ \frac{TR}{\sum FTDS} - \left( \left( \frac{ATDS_t - FTDS_t}{ATDS_t} \right) \times \frac{TR_{Fixed}}{\sum FTDS} \right) \right] \times CPIH \text{ adjustment factor}_t$$

$$ABR_t = (RR_{t-2} - R_{t-2}) \times \left[ 1 + \frac{D}{100} \right]^2 \times (1 + \frac{CPIH_{t-1}}{100}) \times (1 + \frac{CPIH_t}{100})$$

**MAR<sub>t</sub> = Modified average revenue.** For each Charging Year starting on or after 1 April 2020 the modified average revenue expressed in £ per Tonnes of Dried Solid sludge (TDS) allowed to the Appointed Business in respect of Bioresources Activities.

**ATDS<sub>t</sub> Actual volume of sludge (TDS).** This is the total amount of sewage sludge produced (TDS) during the Charging Year produced by the whole service. This will be known after the end of the Charging Year.

**ABR<sub>t</sub> Bioresources revenue adjustment.** This is the difference between the Appointee's allowed revenue and the revenue actually recovered in a Charging Year two years before Charging Year t in respect of Bioresources Activities. Inflation and financing adjustments for two years is applied to this difference. In the Charging Years starting 1 April 2020 and 1 April 2021, this term shall have the value of zero.

**T<sub>t-2</sub> Profit from bioresources trading** expressed in outturn prices in £ millions in year t-2. When appointed assets are used for sludge imports (non-appointed activities), the company will determine a transfer price. This should include at least the incremental cost of treating the imported sludge plus a proportion of the margin from the trade. Companies should refer to [Regulatory accounting guidelines \(RAG\) 5.07](#) when setting their transfer price. The T<sub>t-2</sub> profits from bioresources trading will be the margin element of the transfer prices earned

for trades that occur in year t-2. In the Charging Years starting 1 April 2020 and 1 April 2021, this term shall have the value of zero.

**TR Total revenue requirement calculated at PR19.** This is the total allowed revenue for the five Charging Years starting on 1 April 2020 as set out in the final column of Table 5 below before any in-period adjustments.

$\sum$  **FTDS Total forecast volume of sludge (TDS)** for the five Charging Years starting on 1 April 2020 as set out in the final column of Table 5 below.

**FTDS<sub>t</sub> Forecast volume of sludge (TDS)** produced in year t as set out in Table 5 below.

**TR<sub>Fixed</sub> Total Revenue to remunerate fixed costs** for the five Charging Years starting on 1 April 2020 as set out in Table 5 below

**Table 5: Price Control for Bioresources Activities numbers**

Charging year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
Total revenue allowance over period 2020-25, <b>TR</b> (£million, 2017-18 FYA CPIH deflated prices)	N/A	N/A	N/A	N/A	N/A	457.870
Forecast volume of sludge, <b>FTDS<sub>t</sub></b> (TDS)	237,477	238,240	239,273	239,925	240,978	1,195,893
Revenue to remunerate fixed costs, <b>TR<sub>Fixed</sub></b> (£million, 2017-18 FYA CPIH deflated prices)	N/A	N/A	N/A	N/A	N/A	366.000

**Note:**

There is no Table 4 in this draft determination. This is a deliberate omission that is intended to ensure consistency in Table numbers between different companies.

## 2.5 Price Control for Residential Retail Activities

In respect of the Appointed Businesses' Retail Activities, Ofwat proposes to set one single Price Control for the Appointed Business's Retail Activities relating to the supply of water and the provision of sewerage services to household premises (as defined in section 17C of the Water Industry Act 1991) ("**Residential Retail Activities**").

The Price Control for Residential Retail Activities:

- shall consist of a limit on the total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned; and
- is set for a period of five consecutive Charging Years starting on 1 April 2020.

The total unadjusted revenue, **TR**, allowed to the Appointed Business in each Charging Year in respect of Residential Retail Activities shall be the relevant amount set out in Table 6 as modified in accordance with the following formula:

$$R_t = TR_t + (AC_t - FC_t) \times M_t \times 1000$$

Where:

**TR<sub>t</sub> Total Revenue** The total unadjusted allowed revenue expressed in outturn prices as set out in table 6;

**AC<sub>t</sub> Actual Customers** Actual customer numbers (meaning the average number of individual household premises (as defined in section 17C of the Water Industry Act 1991) supplied or served by the Appointed Business in a Charging Year) expressed in thousands;

**FC<sub>t</sub> Forecast Customers.** Forecast customer numbers set out in table 6;

**M<sub>t</sub> Modification Factor.** The modification factors expressed in outturn prices set out in table 6.

**Table 6: Price Control for Residential Retail Activities numbers**

Charging year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
TR (£million, outturn)	107.761	109.643	111.531	113.411	115.285	-
M (£, outturn)	26.20	26.50	26.80	27.08	27.36	-
FC (thousands)	4,112.970	4,136.772	4,162.040	4,187.738	4,213.864	-

## 2.6 Demonstrating Compliance with the Price Controls

The Appointee shall provide such information as Ofwat may reasonably require in relation to annual regulatory reporting to demonstrate how the Appointee is complying, or has complied, with its obligation to levy charges in a way best calculated to comply with each Price Control applicable to it.

## **Appendix 1: Notified Items and Land Sales**

### **Notified Items**

Ofwat does not propose to notify the Appointee of any item that has not been allowed for (either in full or at all) when making the final determination of Price Controls.

### **Land sales**

When making the final determination of Price Controls Ofwat proposes to give notice that for each of the five consecutive Charging Years starting on or after 1 April 2020:

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

## Appendix 2: In-period Outcome Delivery Incentives (ODIs)

Ofwat proposes to notify the Appointee in accordance with Part 3A of Condition B that the Price Controls to be determined in respect of the Appointee’s Retail Activities, Water Resources Activities, Bioresources Activities, Network Plus Water Activities and Network Plus Wastewater Activities may be adjusted to reflect the Appointee’s performance in relation to the following Performance Commitments:

**Table A2.1: In-period financial performance commitments: Common PCs**

<b>Name of Common Performance Commitment</b>	<b>Type of Outcome Delivery Incentive (ODI)</b>	<b>Price controls ODIs will apply to</b>
Water quality compliance (CRI) [PR19 SVE_H01]	Financial – Under; In-period	Water resources; Water network plus
Water supply interruptions [PR19 SVE_G01]	Financial - Out & under; In-period	Water network plus
Leakage [PR19 SVE_G02]	Financial – Out & under; In-period	Water network plus
Per capita consumption [PR19 SVE_G03]	Financial - Under; In-period	Water resources
Mains repairs [PR19 SVE_G04]	Financial - Out & under; In-period	Water network plus
Unplanned outage [PR19 SVE_G05]	Financial – Under; In-period	Water resources; Water network plus
Internal sewer flooding [PR19 SVE_F01]	Financial - Out & under; In-period	Wastewater network plus
Pollution incidents [PR19 SVE_F02]	Financial – Out & under; In-period	Wastewater network plus
Sewer collapses [PR19 SVE_F03]	Financial – Out & under; In-period	Wastewater network plus
Treatment works compliance [PR19 SVE_C01]	Financial – Under; In-period	Water network plus; Wastewater network plus
C-MeX: Customer measure of experience [PR19 SVE_D01]	Financial - Out & under; In-period	Residential retail
D-Mex: Developer services measure of experience [PR19 SVE_D02]	Financial - Out & under; In-period	Water network plus; Wastewater network plus



**Table A2.2: In-period financial performance commitments: Bespoke PCs**

<b>Name of Bespoke Performance Commitment</b>	<b>Type of Outcome Delivery Incentive (ODI)</b>	<b>Price controls ODIs will apply to</b>
Reducing residential void properties [PR19 SVE_A01]	Financial – Out; In-period	Residential retail
Reducing business void and gap site supply points [PR19 SVE_A03]	Financial – Out; In-period	Business retail
Inspiring our customers to use water wisely [PR19 SVE_B01]	Financial – Out & under; In-period	Water network plus, wastewater network plus
Biodiversity (Water) [PR19 SVE_C03]	Financial – Out & under; In-period	Water resources
Biodiversity (Waste) [PR19 SVE_C04]	Financial - Out & under; In-period	Wastewater network plus
Satisfactory sludge use and disposal [PR19 SVE_C05]	Financial – Under; In-period	Bioresources
External sewer flooding [PR19 SVE_F05]	Financial - Out & under; In-period	Wastewater network plus
Sewer blockages [PR19 SVE_F06]	Financial - Out & under; In-period	Wastewater network plus

Public sewer flooding [PR19 SVE_F07]	Financial - Out & under; In-period	Wastewater network plus
Green communities [PR19 SVE_F08]	Financial - Out & under; In-period	Wastewater network plus
Speed of response to visible leaks [PR19 SVE_G07]	Financial - Out & under; In-period	Water network plus
Persistent low pressure [PR19 SVE_G08]	Financial - Out & under; In-period	Water network plus
Abstraction Incentive Mechanism (AIM) [PR19 SVE_G09]	Financial - Out & under; In-period	Water resources
Resolution of low pressure complaints [PR19 SVE_G11]	Financial - Out & under; In-period	Water network plus, residential retail
Number of water meters installed [PR19 SVE_G13]	Financial - Out & under; In-period	Water resources
Water quality complaints [PR19 SVE_H02]	Financial - Out & under; In-period	Water resources, water network plus

### Appendix 3: Revenue Forecasting Incentive formula

On the assumption that an appropriate modification is made to Condition B (Charges) before December 2019, Ofwat proposes to notify the Appointee that subparagraph 9.1 of Condition B will not prevent the Appointee from levying charges to recover a Relevant Shortfall in the Charging Years beginning 1 April 2021, 1 April 2022, 1 April 2023 and 1 April 2024 (each of which will be a “Relevant Charging Year” for these purposes) where the “Relevant Shortfall” means any positive amount calculated for a Relevant Charging Year in accordance with the following formula:

#### Revenue Forecasting Incentive: wastewater network-plus

The RFI for wastewater network plus activities will be determined according to the following formula:

$$\begin{aligned} \mathbf{RFI}_t = & - ( \mathbf{RR}_{t-2} - \mathbf{AR}_{t-2} ) \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right)^2 \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \\ & - \frac{\mathbf{PR}}{\mathbf{100}} \times | \mathbf{RR}_{t-2}^{\mathbf{XD}} - \mathbf{AR}_{t-2}^{\mathbf{XD}} | \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right) \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \end{aligned}$$

The RFI for wastewater network plus activities,  $\mathbf{RFI}_t$  is added to allowed revenues for wastewater network plus activities,  $\mathbf{R}_t$ , to calculate adjusted allowed revenues for wastewater network plus activities, according to the following formula:

$$\mathbf{AR}_t = \mathbf{R}_t + \mathbf{BYA}_t + \mathbf{RFI}_t$$

#### Revenue Forecasting Incentive: Water network-plus

The RFI for water network plus activities will be determined according to the following formula:

$$\begin{aligned} \mathbf{RFI}_t = & - ( \mathbf{RR}_{t-2} - \mathbf{AR}_{t-2} ) \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right)^2 \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \\ & - \mathbf{PS}_{i,t} \times \frac{\mathbf{PR}}{\mathbf{100}} \times | \mathbf{RR}_{t-2}^{\mathbf{XD}^*} - \mathbf{AR}_{t-2}^{\mathbf{XD}^*} | \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right) \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \end{aligned}$$

The RFI for water network plus activities,  $\mathbf{RFI}_t$  is added to allowed revenues for water network plus activities,  $\mathbf{R}_t$ , to calculate adjusted allowed revenues for water network plus activities, according to the following formula:

$$\mathbf{AR}_t = \mathbf{R}_t + \mathbf{BYA}_t + \mathbf{RFI}_t$$

### Revenue Forecasting Incentive: Water resources

The RFI for water resources activities will be determined according to the following formula:

$$\mathbf{RFI}_t = - (\mathbf{RR}_{t-2} - \mathbf{AR}_{t-2}) \times \left(1 + \frac{\mathbf{D}}{100}\right)^2 \times (1 + \mathbf{CPIH}_{t-1}) \times (1 + \mathbf{CPIH}_t) \\ - \mathbf{PS}_{i,t} \times \frac{\mathbf{PR}}{100} \times |\mathbf{RR}_{t-2}^{\mathbf{XD}^*} - \mathbf{AR}_{t-2}^{\mathbf{XD}^*}| \times \left(1 + \frac{\mathbf{D}}{100}\right) \times (1 + \mathbf{CPIH}_{t-1}) \times (1 + \mathbf{CPIH}_t)$$

The RFI for water resources,  $\mathbf{RFI}_t$  is added to allowed revenues for water resources,  $\mathbf{R}_t$ , to calculate adjusted allowed revenues for water resources, according to the following formula:

$$\mathbf{AR}_t = \mathbf{R}_t + \mathbf{BYA}_t + \mathbf{RFI}_t$$

Where for each of controls to which the RFI relates:

$$\mathbf{BYA}_t = \mathbf{TBYA} \times \mathbf{Y}_t \times \left(1 + \frac{\mathbf{D}}{100}\right)^{\mathbf{T} - 2019} \times \mathbf{CPIH} \text{ adjustment factor}_t$$

$\mathbf{AR}_{t-2}$  The adjusted allowed revenue stated in £ millions in charging year t-2 with the first year starting on 1 April 2020.

$\mathbf{RR}_{t-2}^{\mathbf{XD}}$  As  $\mathbf{RR}_{t-2}$  but excludes revenues related to developer services<sup>5</sup>.

$\mathbf{AR}_{t-2}^{\mathbf{XD}}$  As  $\mathbf{AR}_{t-2}$  but excludes revenues related to developer services.

---

<sup>5</sup> Revenue related to developer services should be consistent with 2E.7 and 2E.14 of the Regulatory Accounting Guidelines 4.08.

**RR<sub>t-2</sub><sup>XD\*</sup>** This has the same meaning as **RR<sub>t-2</sub><sup>XD</sup>**, except in this case the relevant controls this applies to are the sum of both the water network-plus and water resource controls.

**AR<sub>t-2</sub><sup>XD\*</sup>** This has the same meaning as **AR<sub>t-2</sub><sup>XD</sup>**, except in this case the relevant controls this applies to are the sum of both the water network-plus and water resource controls.

**PR** The penalty rate. Denoting the forecast error  $(RR^{*t-2} - AR^{*t-2}) / AR^{*t-2} = x\%$ , the penalty rate is:

- 3% for all variations if  $|x\%| > 3\%$ ;
- $3\% * (|x\%| - 2\%) / (3\% - 2\%)$  if  $2\% < |x\%| \leq 3\%$ ;
- zero if  $|x\%| \leq 2\%$ .

The result enters the above formula as a number. For example, for a penalty rate of 3%, PR enters the formula as number 3.

**PS<sub>i,t</sub>** is the share of the penalty that the Appointee chooses to allocate to the control in charging year t,

- where i = water network-plus or water resources control; and
- the **PS<sub>i</sub>** values must sum to one<sup>6</sup> for each charging year.

**BYA<sub>t</sub>** The blind-year adjustment, stated in £ millions, to the allowed revenue of the relevant network plus control<sup>7</sup> in each year over the charging years 2021/22 to 2024/25, inclusive.

**TBYA** = Blind year adjustment stated by Ofwat in 2017/18 year average prices. Any such adjustment would be made by a future determination.

**Y<sub>t</sub>** is the percentage of the blind year adjustment that the company has elected to receive in period t of the AMP. This allows the company to spread the impact of the blind year adjustment over the relevant years. The Y<sub>t</sub> values must

---

<sup>6</sup> That is, **PS<sub>water resources</sub> + PS<sub>water network plus</sub> = 1**

<sup>7</sup> The blind-year adjustments will be made to the relevant network-plus control; it cannot be allocated to the water resources control.

- sum to one, if the blind year adjustment is negative;
- sum to one or less, if the blind year adjustment is positive; and
- be greater than or equal to zero.

**T** = the year in which the relevant charging year begins – for example

- for the charging year 2022-23 then  $T = 2022$ ;
- for the charging year 2023-24 then  $T = 2023$ ; and
- for charging year year 2024-25 then  $T = 2024$ .

## Appendix 4: Glossary

Common terms used in formulae in this document are defined below.

Term	Where used	Definition
<b>t</b>	All	A suffix added to a term to indicate the Charging Year. For example, $R_t$ refers to the relevant Charging Year.
<b>t-1</b>	All	A suffix added to a term to indicate the Prior Year. For example, $R_{t-1}$ refers to the Charging Year starting one year before the start of relevant Charging Year.
<b>t-2</b>	All	A suffix added to a term to indicate the Charging Year commencing on 1 April immediately prior to the Prior Year. For example, $R_{t-2}$ refers to the Charging Year starting two years before the start of the relevant Charging Year.
<b><math>R_t</math></b>	Network-plus, water resources, bioresources	Revenue stated in £ millions allowed to the Appointed Business in a Charging Year by a Price Control in respect of the activities concerned
<b><math>RR_t</math></b>	Bioresources, RFI	The revenue stated in £ millions recovered by the Appointed Business in a Charging Year in outturn prices. In both the RFI and Price Control for Bioresources Activities, the first year, t, starts on 1 April 2022 so that year t-2 starts on 1 April 2020.
<b><math>CPIH_t</math></b>	Network-plus, water resources, bioresources, RFI	The percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for the immediately preceding November.
<b>FYA <math>CPIH</math></b>	Water resources, bioresources	The percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the average level of the Consumer Prices Index (H) across the twelve months of the Charging Year compared to the average level of the Consumer Price Index (H) across the twelve months of the Prior Year.
<b><math>K_t</math></b>	Network-plus, water resources	A specified number for the relevant Charging Year which may be a positive number or a negative number or zero.
<b>D</b>	Water resources, RFI	The specified discount rate of [to be set at the final determination], which enters the relevant formula as an integer. We will use the Weighted Average Cost of Capital (WACC) that we use to set Price Controls in the final determination and apply this constantly over the period.
<b><math>CPIH</math> adjustment factor<sub>t</sub></b>	Water resources, Bioresources, RFI,	One plus the percentage change in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for November 2016.

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.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

April 2019

© Crown copyright 2019

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit [nationalarchives.gov.uk/doc/open-government-licence/version/3](http://nationalarchives.gov.uk/doc/open-government-licence/version/3).

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk).

Any enquiries regarding this publication should be sent to us at [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk).

