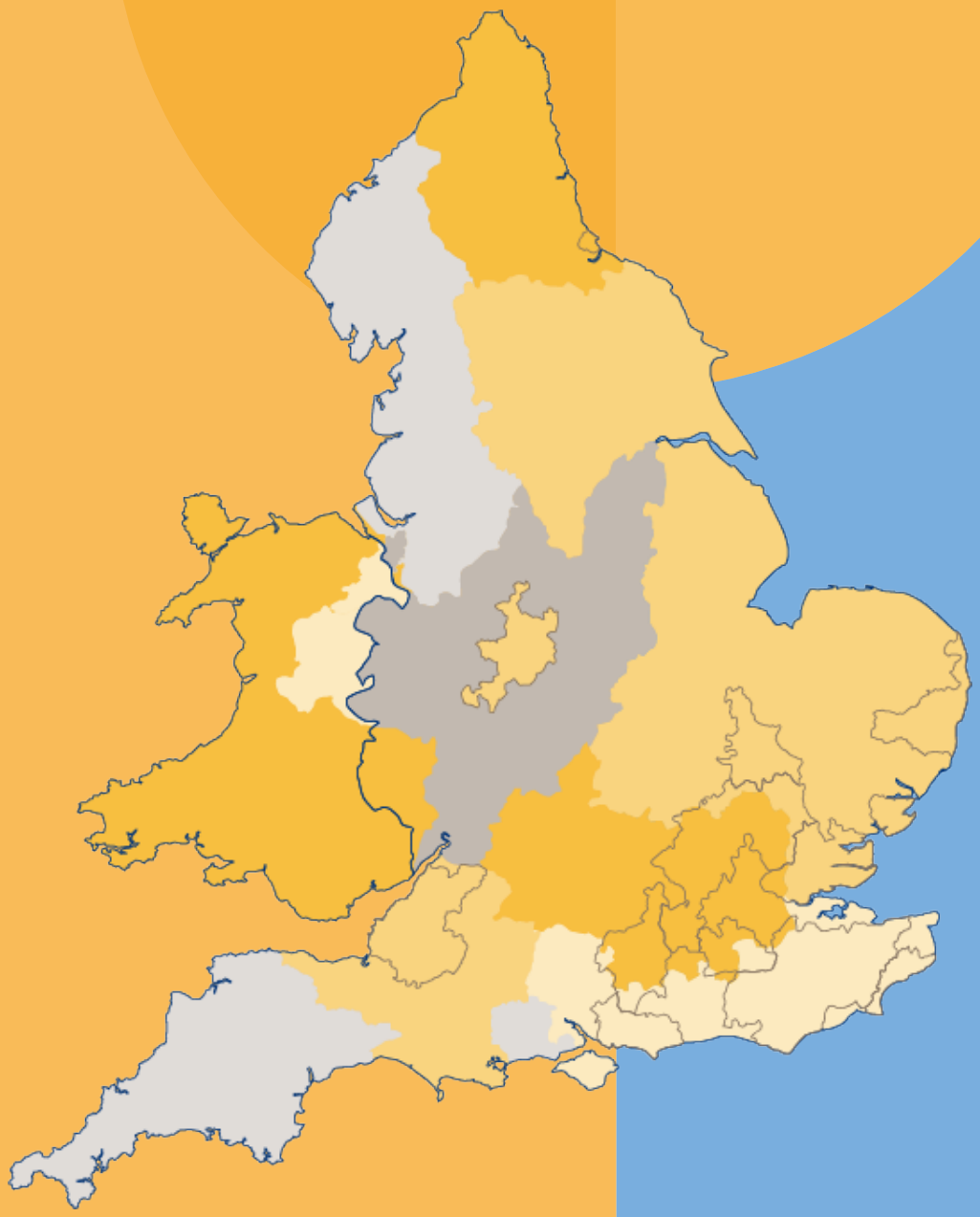
July 2019

Trust in water

# PR19 draft determinations

## South East Water draft determination



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# PR19 draft determinations: South East Water draft determination

# About this document

This document, together with the 'Notification of the draft determination of price controls for South East Water', sets out for consultation the details of the draft determination of price controls, service and incentive package for South East 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 East Water to deliver;
- the allowed revenue that South East Water can recover from its customers; and
- how we have determined allowed revenues based on our calculation of efficient costs and the allowed return on capital.

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

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

This draft determination is in accordance with our PR19 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, including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

All of the responses to the initial assessment of business plans, including all of the companies' revised business plans, provided by 1 April 2019 are taken into account in our decisions where relevant. Where appropriate, we explicitly set out our response to points and issues raised by respondents.

Our decisions also take into account the representations made on the fast track draft determinations where points and issues raised are relevant to the slow track and significant scrutiny draft determinations. We will deal with the other elements of the representations on the fast track draft determinations as part of the final determinations.

We have not necessarily been able to take full account of all late evidence, submitted after 1 April 2019 business plans, and we will consider this information for the final determination.

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

- PR19 draft determinations: South East Water - Cost efficiency draft determination appendix

- PR19 draft determinations: South East Water - Outcomes performance commitment appendix
- PR19 draft determinations: South East Water - Accounting for past delivery appendix
- PR19 draft determinations: South East Water - Allowed revenue appendix

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

## How to respond

Written representations on the draft determinations should be provided to us by 10am on 30 August 2019. Representations can be made by all stakeholders. Representations can be sent either to our PR19 inbox (PR19@Ofwat.gov.uk) or by post to our Birmingham office address: Ofwat, Centre City Tower, 7 Hill Street, Birmingham, B5 4UA.

To ensure transparency, we expect companies to publish their representations in full. We also intend to publish all the written representations we receive on our website once our final determinations are made.

In view of this, if respondents consider that some of the information in their representations should not be disclosed (for example, because they consider it is commercially sensitive information) they should identify that information and explain why. We would expect strong, robust reasons that are specific to the information concerned. We will take such explanations into account, but we cannot give an assurance that information included in representations will not be disclosed.

Where companies are making representations, they should consider what further evidence may be necessary to submit with their representations as a result of this draft determination. Where companies consider that we have not appropriately considered any points previously raised by the company, companies should include this within their representations. Companies should provide a completed ‘All company representation pro forma’ alongside any representations.

We will publish South East Water’s final determination on 11 December 2019 after considering representations (from all stakeholders) on the draft determination and other relevant matters. If South East Water accepts the final determination, it will be accepting that it has adequate funding to properly carry out the regulated business, including meeting its statutory and regulatory obligations, and to deliver the outcomes within its final determination.

# Contents



Correction

The discussion of uncertainty mechanisms in section 4.4 was updated on 22 July 2019.

# 1 Summary

Through PR19 we are enabling, incentivising and challenging water companies to address the key issues facing the sector of climate change, a growing population and ever increasing customer expectations about service. We expect companies to look well beyond the five year price review period to meet needs of future customers and protect and improve the natural environment.

Our PR19 methodology set out a framework for companies to address these challenges, with particular focus on improved service, affordability, increased resilience and greater innovation. Our draft determinations are based on our detailed review of the revised plans submitted to us on 1 April. We are intervening, where required, to protect customers.

## 1.1 What the draft determination will deliver

Our draft determination for South East Water will cut average bills by 9.7% in real terms in the 2020-25 period compared to the company's proposed 0.6% reduction. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in April 2019 and our draft determination. Average bills are lower than proposed by South East Water, to reflect our view of efficient costs. Further details on bills are set out in section 6.

**Table 1.1: Bill profile for 2020-25 before inflation**

| | 2019-20 | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 |
|---|---|---|---|---|---|---|
| Company plan (April resubmission) | £205 | £204 | £204 | £204 | £204 | £204 |
| Draft determination | £205 | £185 | £185 | £185 | £185 | £185 |

Our draft determination allows South East Water £172 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £67 million to improve the environment by efficiently delivering its obligations as set out in the Water Industry National Environment Programme (WINEP), including to mitigate the risk transferring invasive non-native species
- £16 million to address the impact of deteriorating raw water quality; and
- £49 million to improve the water supply demand balance.

In addition we allow an uplift in modelled growth costs of £42 million to accommodate the challenges of supplying areas of high development such as Ashford and Basingstoke.

Further details on our cost allowances are set out in section 3.

Our draft determination package includes a full set of performance commitments, specifying the minimum level of service that South East Water must commit 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.

The performance commitments require South East Water to deliver service improvements by reducing water supply interruptions and reducing the numbers of contact received from customers about water appearance. South East Water will deliver environmental benefits by reducing greenhouse gas emissions, leakage and per capita consumption. The company will also provide more support for vulnerable customers by 2024-25. Further details of performance commitments are set out in Table 1.2 below and in section 2.

**Table 1.2: Key commitments for South East Water**

| Area | Measure |
|---|---|
| Overall incentive package | Overall outcome delivery incentive package in our draft determination equates to a return on regulatory equity range of – 2.40% (P10) to + 0.27% (P90). |
| Key common performance commitments | • 15% reduction in annual level of leakage by 2025 from the 2020 level[1].<br>• 8% reduction in per capita consumption by 2024-25<br>• 70% reduction in water supply interruptions by 2024-25<br>• 49% reduction in unplanned outage by 2024-25 |
| Bespoke performance commitments | • 32% reduction in the number of contacts, per 1,000 population, received from customers regarding water appearance by 2024-25<br>• 68% reduction in the amount of greenhouse gas emissions produced per megalitre of treated water by 2024-25 |

Note: The calculations behind these numbers are outlined in the 'South East Water - Outcomes performance commitment appendix'

[1]Whilst the figures in the tables of the 'South East Water - Outcomes performance commitment appendix' which relate to this performance commitment reflect that it is measured on a three-year average to smooth annual variations due to weather, the overall performance commitment target is a reduction in average annual leakage of 16% (from 2019-20 baseline) by 2024-25.

## 1.2 Allowed revenues

Our draft determination sets allowed revenue or average revenue for each of the price controls. Table 1.3 shows the allowed revenues in the draft determination across each price control. Further details on our calculation of allowed revenues are set out in section 4.

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

| | Water Resources | Network plus - water | Wholesale Total | Residential retail |
|---|---|---|---|---|
| Final allowed revenues (£ million) | 102.0 | 913.3 | **1,015.3** | 86.8 |

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

As set out in the 'Cost of capital technical appendix', we are updating our assessment of the cost of capital for South East Water's draft determinations. The updated cost of capital is 3.19% (on a CPIH basis, 2.19% on a RPI basis) at the level of the Appointee, a reduction of 0.21% from our early view set out in the PR19 methodology.

We consider that South East Water's draft determination is financeable, based on an efficient company, with the notional capital structure, and is sufficient to deliver its obligations, including to ensure a long term resilient service. Each company is responsible for ensuring its capital and financial structure allows it to maintain financial resilience over the short and the long term. We expect South East Water to take account of this requirement, and provide appropriate Board assurance that it will remain financeable on a notional and actual basis and can maintain its long term financial resilience, taking account of the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the cost of capital in very recent market data, in its response to our draft determination. Further detail on our assessment of financeability is set out in section 5.

We have encouraged companies to take greater account of customers' interests – and to transparently demonstrate that they are doing so in the way they finance themselves, pay dividends to their shareholders, and determine performance related executive pay. South East Water has committed to meeting the expectations set out in our 'Putting the sector in balance position statement'. It has confirmed it will apply our gearing outperformance mechanism. The company is taking steps to

demonstrate how its dividend and performance related executive pay policies in 2020-25 will align with customer interests. However, we expect the company to continue to take steps in these areas to meet our expectations.

In the 'Putting the sector in balance' position statement, we also encouraged companies to adopt voluntary sharing mechanisms, particularly where, for example, companies outperform our cost of debt assumptions. South East Water has not proposed any voluntary sharing mechanisms. In its revised business plan South East Water sets out an intention to reduce its gearing to around 75%. We expect the company to keep us informed of its progress on achieving its stated gearing reduction and to set out its progress in its Annual Performance Reports.

## 1.3 Where we intervene

Our initial assessment of South East Water's plan on 31 January 2019 assessed the plan as slow track. We identified a number of areas where material interventions were required to make sure customers' interests are protected. In its 1 April 2019 revised business plan, South East Water has not adequately responded to our concerns. We have therefore made further targeted material interventions in South East Water's plan in the following areas:

- We align total expenditure (totex) allowances to our view of efficient costs using the comparative information available to us and because the company did not provide convincing evidence to explain why its proposed costs were higher than our view of efficient costs. This intervention reduces South East Water totex costs by 12.2%, saving customers £133 million.
- We make a partial allowance for enhancement expenditure for leakage reduction, we only fund the element of the company's performance commitment beyond the forecast upper quartile. We expect an efficient company to achieve leakage reduction below this level.
- We increase financial incentives on supply interruptions and both the performance commitment and underperformance incentive on mains repairs.
- We increase the reduction in per capita consumption to 8% by 2024-25, based on the range the company discussed in its business plan.

We set out further detail of our interventions in this document in this document and in the South East Water actions and interventions documents.

# 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.

There are two key elements of the outcomes framework: performance commitments and outcome delivery incentives. 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. Outcome delivery incentives specify the financial or reputational consequences for companies of outperformance or underperformance against each of these commitments. (They are referred to as 'out' where there is a payment to the company for better than committed performance, 'under' where there is a payment to customers where there is worse than committed performance, or 'out-and-under' incentives, depending on their design). Most outcome delivery incentives will be settled at the end of each year to bring incentives closer to the time of delivery of the service ('in-period' incentives) and some will be settled once at the end of the five year period ('end-of period' incentives). The outcomes framework gives companies the freedom to innovate and explore to find the most cost-effective way of delivering what matters to their customers.

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 legal obligations, or risk enforcement action. If a company's performance falls below the level set for a performance commitment (irrespective of the existence of any deadband or collar), 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.

Please see the 'Delivering outcomes for customers policy appendix' for further details on our policy decisions on cross-cutting issues such as common performance commitments and outcome delivery incentive rates.

## 2.1 Customer engagement

In our PR19 methodology we set out our expectations that companies should demonstrate ambition and innovation in their approach to engaging customers as they develop their business plans. This includes direct engagement with customers to develop a package of performance commitments and outcome delivery incentives.

We expect customer challenge groups to provide independent challenge to companies and independent assurance to us on: the quality of a company's customer engagement; and the degree to which this is reflected in its business plan.

We continue our assessment of customer engagement evidence following each company's submission of its response to our initial assessment of its plan in April 2019. We find variability in both the quality of engagement undertaken by companies and the extent to which customers' views are reflected in company proposals.

South East Water's plan shows evidence of high quality customer engagement in some areas, but fell short in other areas. Areas that showed high quality evidence included: effective use of a wide range customer engagement techniques; adoption of the four areas of customer participation action set out in the Tapped In report ('futures', 'action', 'community', 'experience'), and; engagement on the business plan and on longer term issues in general, including considering the needs of future customers.

South East Water responds to concerns identified in our initial assessment of the plan about ongoing engagement with customers, use of quantitative data and application of segmentation and, additionally, presents evidence of testing the acceptability and affordability of the next and following price review period plans. We find the recent research to be of a satisfactory quality.

The company's customer challenge group commented: 'Overall, it is the customer challenge group's view that South East Water's research to test the acceptability and affordability of the combined water and wastewater bill for 2020-25, and its longer-term bill profile, is acceptable'. The customer challenge group also explained ongoing work about the shape and coverage of new financial support packages: the company states that it will provide an update to the customer challenge group in November 2019.

## 2.2 Performance commitments and outcome delivery incentives

South East Water's performance commitments and outcome delivery incentives for the 2020-25 period are listed in Table 2.2 and Table 2.3. The detail of these performance commitments and outcome delivery incentives are set out in the 'South East Water - Outcomes performance commitment appendix'. The performance commitments and outcome delivery incentives include the revisions accepted by the company in response to our 31 January 2019 initial assessment of business plans and any additional interventions we are making in the draft determination.

The material interventions we are making in the draft determination are set out in Table 2.1 below. 'South East Water – Delivering outcomes for customers actions and interventions' sets out in detail our interventions in the company's performance

commitments and outcome delivery incentives following our 31 January 2019 initial assessment of plans.

### Table 2.1: Summary of key interventions on outcomes

| Intervention description |
|---|
| Accepting the company's leakage reduction proposals of above 15% on an annual average basis, which will take it to a performance level better than industry upper quartile by 2024-25.<br><br>Accepting the company's outcome delivery incentive rates in relation to leakage. |
| Increasing the reduction in per capita consumption to 8% by 2024-25, based on the range the company discussed in its business plan. South East Water has the highest per capita consumption in England and Wales and operates in a water stressed area, so it is vital that more rapid progress is made in helping customer use water wisely.<br><br>Accepting the company's outcome delivery incentive rates in relation to per capita consumption. |
| Accepting the company' water supply interruption reduction proposal of 70% by 2024-25, which will move the company from lower quartile performance to the forecast upper quartile on a sector basis. We are setting an industry wide glide path for all years before 2024-25.<br><br>Increasing the underperformance rate for water supply interruptions, given its own PR14 rates and the company's recent poor performance on this measure and increasing the outperformance rate to provide incentives for delivery. |
| Increasing the company's mains repairs reduction proposal from no improvement to 16% improvement by 2024-25, based on its 3 best years of historic performance.<br><br>Increasing the company’s underperformance rate in relation to mains repairs given the company’s comparatively poor recent performance and its failure to provide sufficient evidence of its ability to deliver on the measure for the 2020-25 period. |
| Accepting the ‘engaging and working with landowners’ performance commitment which measures the number of hectares benefiting from catchment management. This performance commitment encourages the company to work with farmers to change their land management practices. |
| Accepting a suite of performance commitments that measure satisfaction of household customers by segment. The company provides good evidence that the approach and methodology is based on good practice. |
| Increasing the underperformance rate for the water quality contacts (appearance of tap water) performance commitment to industry average since the company has not provided sufficient evidence of its ability to deliver in this area. |
| Increasing the target performance commitment level reduction in relation to unplanned outage to 49% improvement as this will push the company to the median level. |

### Table 2.2: Summary of performance commitments: common performance commitments

| Name of common performance commitment | Type of outcome delivery incentive | Price controls outcome delivery incentives will apply to |
|---|---|---|
| Water quality compliance (CRI) [PR19SEW_A.1] | Financial - Under; In-period | Water resources; Water network plus |
| Water supply interruptions [PR19SEW_B.1] | Financial - Out & under; In-period | Water resources; Water network plus |
| Leakage [PR19SEW_D.1] | Financial - Out & under; In-period | Water network plus |
| Per capita consumption [PR19SEW_E.1] | Financial - Out & under; In-period | Water network plus; Residential retail |
| Mains repairs [PR19SEW_B.2] | Financial - Under; In-period | Water network plus |
| Unplanned outage [PR19SEW_B.3] | Financial - Under; In-period | Water resources; Water network plus |
| Risk of severe restrictions in a drought [PR19SEW_G.1] | Reputational | N/A |
| Priority services for customers in vulnerable circumstances [PR19SEW_J.1] | Reputational | N/A |
| C-Mex: Customer measure of experience [PR19SEW_C.1] | Financial - Out & under; In-period | Residential retail |
| D-Mex: Developer services measure of experience [PR19SEW_F.1] | Financial - Out & under; In-period | Water network plus |

### Table 2.3: Summary of performance commitments: bespoke performance commitments

| Name of bespoke performance commitment | Type of outcome delivery incentive | Price controls outcome delivery incentives will apply to |
|---|---|---|
| Segmented satisfaction of household customers - segment 1 [PR19SEW_C.2] | Reputational | N/A |
| Segmented satisfaction of household customers - segment 2 [PR19SEW_C.3] | Reputational | N/A |
| Segmented satisfaction of household customers - segment 3 [PR19SEW_C.4] | Reputational | N/A |
| Segmented satisfaction of household customers - segment 4 [PR19SEW_C.5] | Reputational | N/A |
| Segmented satisfaction of household customers - segment 5 [PR19SEW_C.6] | Reputational | N/A |
| Segmented satisfaction of household customers - segment 6 [PR19SEW_C.7] | Reputational | N/A |
| Satisfaction of household customers who are experiencing payment difficulties [PR19SEW_C.8] | Reputational | N/A |
| Satisfaction of household customers who are receiving non-financial support [PR19SEW_C.9] | Reputational | N/A |
| Satisfaction of household customers on our vulnerability schemes during a supply interruption [PR19SEW_C.10] | Reputational | N/A |
| Appearance of tap water [PR19SEW_A.2] | Financial - Out & under; In-period | Water resources; Water network plus |
| Taste and odour of tap water [PR19SEW_A.3] | Financial - Out & under; In-period | Water resources; Water network plus |
| Household customers receiving financial support [PR19SEW_I.1] | Reputational | N/A |
| Satisfaction of stakeholders in relation to assistance offered by South East Water [PR19SEW_J.2] | Reputational | N/A |
| Gap sites [PR19SEW_L.1] | Reputational | N/A |
| Voids – household properties [PR19SEW_L.2] | Financial - Out & under; In-period | Water network plus; Residential retail |
| Voids – business properties [PR19SEW_L.3] | Financial - Out & under; In-period | Water network plus |

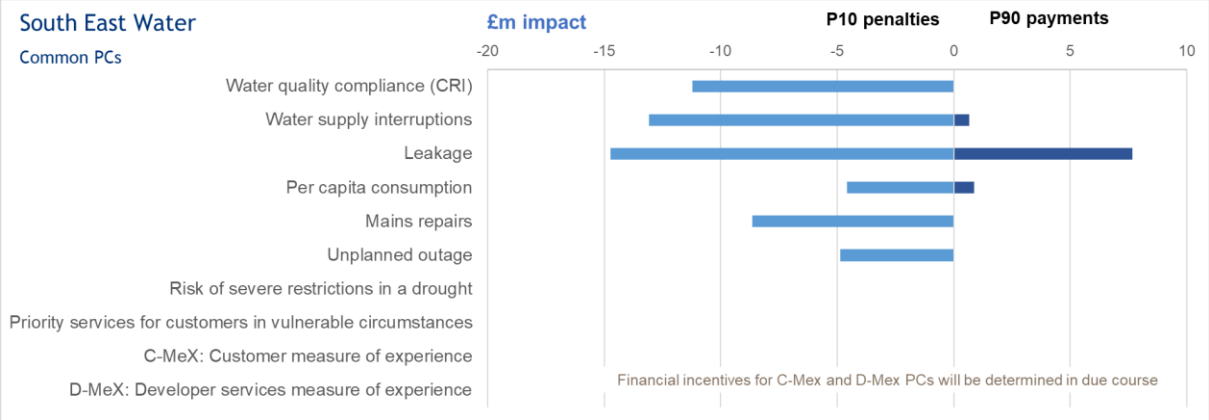
| Name of bespoke performance commitment | Type of outcome delivery incentive | Price controls outcome delivery incentives will apply to |
|---|---|---|
| Company sites protected from risk of flooding [PR19SEW_B.4] | Financial - Under; End of period | Water resources; Water network plus |
| Event Risk Index (ERI) [PR19SEW_B.5] | Reputational | N/A |
| Low pressure [PR19SEW_B.6] | Financial - Out & under; In-period | Water network plus |
| Engaging and working with landowners and land managers to improve catchment resilience related to raw water quality deterioration [PR19SEW_H.1] | Financial - Out & under; End of period | Water resources |
| Protecting wildlife and increasing biodiversity [PR19SEW_H.2] | Financial - Out & under; End of period | Water resources; Water network plus |
| Water Industry National Environment Programme [PR19SEW_H.3] | Financial - Under; In-period | Water resources |
| Greenhouse gas emissions [PR19SEW_H.4] | Reputational | N/A |
| Bespoke Abstraction Incentive Mechanism (AIM) [PR19SEW_H.5] | Financial - Under; In-period | Water resources |
| Engaging and working with abstractors to improve catchment resilience to low flows [PR19SEW_H.6] | Reputational | N/A |
| Satisfaction with value for money [PR19SEW_C.11] | Reputational | N/A |
| WINEP Delivery [PR19SEW_NEP01] | Reputational | N/A |

Figure 2.1 and Figure 2.2 below provide an indication of the financial value of each of South East Water's outcome delivery incentives (taking into account the impact of our draft determination interventions) showing how much the company would have to return to customers if it underperformed to the P10 level and how much the company would gain if it over performed to the P90 level. The figures cover common and bespoke commitments respectively.

Table 2.4 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 (return on regulated equity)) 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 2.4: Impact of draft determination interventions on RoRE range**

| | April 2019 business plan | | Draft determination | |
|---|---|---|---|---|
| | % of 5 year regulatory equity | | % of 5 year regulatory equity | |
| | P10 | P90 | P10 | P90 |
| South East Water | -1.99 | +0.28 | -2.40 | +0.27 |

In the PR19 methodology we said that we expect companies to propose approaches to protect customers in case their outcome delivery incentive payments turn out to be much higher than expected. We asked companies in our initial assessment of business plans 'PR19 initial assessment of plans: Delivering outcomes for customers policy appendix' to put in place additional protections for customers where we considered protections were not adequate.

We are applying caps and collars to financially material and/or highly uncertain performance commitments and allowing caps and collars on other performance commitments where company proposals are supported by high quality customer engagement.

The company has accepted our standard sharing mechanism, where 50% of outperformance payments that exceed 3% of return on regulatory equity (RoRE) in any year are shared with customers through bill reductions in the following year. We accept this proposal. We set out further detail of the mechanism in 'Delivering outcomes for customers policy appendix'.

In our PR19 methodology, we decided to replace the current Service Incentive Mechanism (SIM) with two new mechanisms to incentivise companies to provide a great experience for residential customers (our customer measure of experience, or C-MeX) and developer services customers (our developer services measure of experience, or D-MeX). C-MeX and D-MeX will be operational from April 2020. We set out further details on C-MeX and D-MeX in the 'Delivering outcomes for customers policy appendix'. We will publish our decisions on C-Mex and D-Mex incentive designs for 2020-25 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, so that these can be reflected as appropriate in the company's final determination to be published in December.

## 2.3 Linking outcomes to resilience

During the initial assessment of plans, we were concerned that companies' plans lacked a clear line of sight between the risks to resilience identified, the proposed mitigations presented in the plan to tackle these risks, and how these mitigation plans were reflected as service improvements in the form of stretching performance commitments. In this context, we are intervening to ensure South East Water's asset health challenges are reflected in its outcomes and performance commitments, particularly in relation to the level of stretch and incentives associated with its mains repairs and unplanned outage targets.

Our initial assessment of plans also noted that South East Water provided some evidence linking generic priority risks to its systems and to groups of performance commitments. However, the company provided insufficient evidence to demonstrate the benefit that specific investments have in mitigating quantified levels of risk (and/or in increasing system resilience) and supporting stable or improved commitment targets. We expect companies to address this and other issues associated with the way they integrate resilience across their business in the action plans that will be submitted by 22 August 2019 and in their responses to the draft determinations in relation to specific investment proposals. We will take into account the quality of companies' response in our final determinations.

## 2.4 Deliverability

To maintain trust and confidence, it is important that companies not only have a great business plan but also that customers have confidence that the business plan will be delivered. In our initial assessment of the company's past performance in its business plan South East Water did not provide us with sufficient evidence of the deliverability of its outcome proposals. We required the company to provide further evidence of deliverability and an action plan for continuous improvement in this area. We have considered the additional evidence provided by South East Water to identify whether we need to include additional measures in its draft determinations to incentivise the delivery of its business plan, in particular whether to strengthen the outcome delivery incentives package. The detailed assessment of the company's additional evidence of deliverability is included in 'South East Water - Accounting for past delivery actions and interventions', and our methodology for conducting this assessment is in 'Accounting for past delivery technical appendix'.

We focus our analysis of outcomes on the water supply interruptions, mains repairs, discolouration contacts and customer satisfaction performance commitments, where we had the greatest concerns. The company provides further evidence to support its deliverability and an action plan for continuous improvement.

The company's action plan for continuous improvement is generic, not specific to individual performance commitments. The company provides sufficient evidence in

relation to some elements of the action plan for continuous improvement but there is insufficient evidence in other areas.

For the water supply interruptions performance commitment, the company provides insufficient evidence to support the deliverability of the stretch in its 2020-25 business plan. We are already intervening as part of our outcomes assessment to protect customers by adjusting both the underperformance and outperformance payment rates for this performance commitment. For information on how we are intervening on these rates, please see the 'Delivering outcomes for customers policy appendix'. We do not consider that any further intervention is required as a result of our deliverability assessment.

For the mains repairs performance commitment, the company provides insufficient evidence to support the deliverability of the stretch in its 2020-25 business plan. We are therefore intervening to increase the company's outcome delivery incentive underperformance payment rate to the top of the reasonable range (average +0.5*standard deviation) as we consider that a stronger incentive to deliver is required than the average rate for this performance commitment given past performance, the insufficient evidence on deliverability and the company's comparative performance.

For the discolouration contacts performance commitment, the company provides insufficient evidence to support the deliverability of the stretch in its revised business plan. We are therefore intervening to protect customers given our remaining concerns on deliverability by increasing South East Water's outcome delivery incentive underperformance payment rate to the industry average.

For the customer satisfaction performance commitments, the company provides additional evidence that confirms that many of these performance commitments were set at zero tolerance causing any drop in performance to result in failure in our initial assessment. We do not consider it necessary to intervene:

- as customers are adequately protected by C-MeX, with which there is a significant overlap; and
- given the innovative nature of some of these performance commitments and the company's zero tolerance approach which, whilst leading to more failures, will protect customers' interests.

# 3 Cost allowances

We set out in our PR19 methodology that we expect company business plans to show a step change in efficiency. In its April business plan, South East Water requested total expenditure levels 15% higher than the company had incurred historically, and which were no different from those requested in its September business plan. To ensure customers pay only for efficient costs we challenge these costs, and except for the residential retail price control, we find the proposed costs to be significantly greater than our view of efficient costs. Our allowance for base expenditure is in line with historical levels. We consider the company is efficient in the residential retail price control and have made an allowance greater than requested in this area.

Our main areas of challenge to enhancement costs are resilience, leakage and supply and demand side enhancements, which we describe in the section on enhancement expenditure below.

Our approach to setting total expenditure (totex) allowances is detailed in our publication ‘Securing cost efficiency technical appendix’. In addition to challenging companies to be more efficient we have also, where appropriate, set safeguards to protect customers if specific investments are not delivered as planned.

In the ‘South East Water – Cost efficiency draft determination 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.

## 3.1 Wholesale total expenditure

Table 3.1 shows the totex allowances by year and by wholesale 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 | Company view - total |
|---|---|---|---|---|---|---|---|
| Water resources | 25.3 | 23.7 | 23.3 | 21.5 | 21.4 | 115.3 | 127.6 |
| Water network plus | 131.4 | 156.4 | 164.0 | 146.8 | 153.9 | 752.4 | 879.7 |
| **Total** | **156.8** | **180.1** | **187.3** | **168.2** | **175.3** | **867.7** | **1,007.3** |

1 Totex includes all costs except pension deficit recovery costs. This includes third party costs, operating lease adjustments, allowances related to the development of strategic regional water resource solutions and costs that are assumed to be recovered through grants and contributions.

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 base level.

For draft determinations, we have changed the scope of costs included under base expenditure compared to the initial assessment of plans. Our base costs now include costs associated with the connection of new developments (ie new developments and new connection costs) and costs for addressing low pressure.

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

| | Our cost allowance | | | Company view |
|---|---|---|---|---|
| | Water resources | Water network plus | Total | Company view – total |
| Base expenditure | 78.6 | 615.9 | 694.5 | 743.9 |
| Enhancement expenditure | 36.8 | 135.1 | 171.9 | 261.2 |
| Third party costs | - | 2.2 | 2.2 | 2.2 |
| **Total – excluding pension deficit recovery** | **115.4** | **753.2** | **868.6** | **1,007.3** |
| Pensions deficit recovery costs | 2.5 | 15.0 | 17.5 | 16.4 |
| **Total** | **117.9** | **768.2** | **886.1** | **1,023.7** |

1 We display base costs under the new definition. Company business plan base costs exclude enhancement opex.
2 We are displaying pension deficit recovery costs separately as they are not included in the calculation for PAYG (see section 4).
3 Table 3.2 does not include operating lease adjustments, allowances related to the development of strategic regional water resource solutions. Any ex-ante cost sharing adjustments and costs that are assumed to be recovered through grants and contributions are also excluded. This is to allow a simpler comparison with base and enhancement costs. Table 3.6 sets out a reconciliation of inclusions and exclusions in totex for cost sharing and for the financial model.
4 The company view of pension deficit recovery costs is the full cost, not just the cost the company expects to include within price controls.

## 3.2 Base expenditure

Table 3.3 shows our challenge to company proposed base expenditure. We distinguish between ‘modelled base costs’ and ‘unmodelled base costs’. We challenge modelled based costs based on comparative assessment (using econometric models). Our efficiency challenge is based on cost performance within the sector as well as evidence from the wider economy.

Unmodelled base costs include business rates; abstraction charges and costs to meet the Traffic Management Act where applicable. Our assessment of these costs sits outside of our econometric models and we explain our approach in ‘Securing cost efficiency technical appendix’.

South East Water's business rates forecasts include increases due to revaluation. We have not included increases due to revaluations in our allowance. Our approach to setting allowances for business rates is set out in our 'Securing cost efficiency technical appendix'.

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

| Price Control | Company business plan - base cost | Modelled base costs efficiency adjustment | Unmodelled base costs adjustment | Base cost allowance |
|---|---|---|---|---|
| Water resources | 79.7 | -0.5 | -0.6 | 78.6 |
| Water network plus | 664.2 | -37.1 | -11.2 | 615.9 |
| Total | 743.9 | -37.7 | -11.8 | 694.5 |

Note: Base costs include operating and maintenance costs as well as new development, new connections and addressing low pressure costs. Company business plan base costs exclude enhancement opex.

We assess growth related expenditure through the base cost econometric models. One of the implications of the move to integrated base cost models is that we rely on historical cost performance to forecast efficient expenditure. We consider this is appropriate for routine activities, such as those related to growth. South East Water requested £84.1 million in growth related expenditure, which is assessed through our base cost econometric models. However, we initiated a deep dive of growth costs for a few companies where we considered that the gap between their forecast of growth costs and ours was large. South East Water was one of those companies and we deep dived £58 million that the company included as supply-demand balance expenditure. As this expenditure relates to intra-zonal schemes (rather than inter-zonal) and is largely linked to areas with high development, particularly Ashford and Basingstoke, we consider this to be growth expenditure. After considering the evidence in the business plan we allow £41.8 million for these schemes compared to £58 million which was requested[2].

## 3.3 Enhancement expenditure

Table 3.4 summarises our allowances for enhancement expenditure.

[2] More details can be found in South East Water's cost adjustment claim feeder model.

Our draft determination allows South East Water £172 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £67 million to improve the environment by efficiently delivering its obligations as set out in WINEP, including to mitigate the risk transferring invasive non-native species
- £16 million to address the impact of deteriorating raw water quality; and
- £49 million to improve the water supply demand balance.

The most material areas of enhancement cost challenge for South East Water are in leakage and resilience.

For leakage our expectation for base service levels is that an efficient company should achieve industry forecast upper quartile performance by 2024-25 in both normalised measures (per property and per kilometre of main). This performance is funded through the base allowance. We allow enhancement costs only where a company's performance commitment goes beyond the forecast upper quartile threshold. As this is achieved by South East Water, we allow some funding under enhancement, for the volume of leakage reduction delivered beyond the forecast upper quartile threshold. We use the leakage reduction unit cost the company identifies and apply the company specific efficiency factor to make the allowance. Companies are able to earn outperformance payments if they deliver leakage reductions beyond their stretching performance commitment levels.

We make disallowances for three resilience schemes making up a significant proportion of the proposed water resilience investment. South East Water does not demonstrate the need for investment in line with the resilience definition and our criteria for acceptance. We explain our criteria in 'Securing cost efficiency technical appendix'. There is insufficient evidence that the risks are low probability and high consequence failures that would result in significant interruption to supply. Furthermore, South East Water does not demonstrate sufficiently that mitigating against the failures and their consequences are beyond the company's management control. Immediate risks of supply interruption should be managed by the company's base maintenance proposals and operational activities.

'South East Water - Cost efficiency draft determination appendix sets out in more detail the cost allowances by investment area for each price control, and we give full details in our published models.

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

| Service | Company requested totex | Scope and efficiency adjustment | Our allowance |
|---|---|---|---|
| Water resources | 44.0 | -7.1 | 36.8 |
| Water network plus | 217.2 | -82.1 | 135.1 |
| Total | 261.2 | -89.3 | 171.9 |

## 3.4 Cost sharing

When a company overruns its totex allowance, the additional cost incurred above our allowance will be shared between its investors and customers. When a company spends less than its totex allowance, it will share the benefits with customers.

For the draft determinations we calculate each company's cost sharing rates based on the ratio of the company's view of costs in its September 2018 business plan relative to our view of efficient costs. For the final determinations we propose to calculate the company's view of costs based on a 50% weight on the company's final cost proposals in its representation to the draft determination and 50% weight on the September 2018 business plan. We explain our approach to calculating cost sharing rates in the 'Securing cost efficiency technical appendix'.

**Table 3.5: Totex cost sharing for cost performance for 2020-25, %**

| | Water resources | Network plus - water |
|---|---|---|
| Cost sharing rate – outperformance | 36.9% | 36.9% |
| Cost sharing rate – underperformance | 63.1% | 63.1% |

Table 3.6 sets out the costs that are subject to cost sharing. We apply cost sharing to net totex. Net totex excludes grants and contributions, costs of operating leases, strategic regional water resources development costs, third party costs and pension deficit recovery cost.

We adjust allowed costs 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 to operating costs that the company proposed in its business plan.

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

| | Water resources | Network plus – water | Company view |
|---|---|---|---|
| Gross totex (excluding third party costs) | 115.4 | 751.0 | 1,007.3 |
| Grants and contributions | 0.0 | -57.9 | -63.0 |
| Operating leases adjustment | -0.2 | -0.7 | -0.9 |
| **Net totex (subject to cost sharing)** | 115.3 | 692.3 | 943.4 |
| Strategic regional water resources solutions[2] | 0.0 | 0.0 | 0.0 |
| Third party costs | 0.0 | 2.2 | 2.2 |
| Ex-ante cost sharing adjustment | 0.0 | 0.0 | 0.0 |
| **Net totex (for financial model)** | 115.3 | 694.6 | 945.6 |

[1] Table 3.6 does not include pension deficit repair expenditure, as this is not included in cost sharing.
[2] The standard totex cost sharing does not apply to strategic regional water resource solution expenditure, see 'Strategic regional water resources solution appendix' for more details.

## 3.5 Transition expenditure

South East Water does not request any expenditure under the transition programme.

## 3.6 Residential retail

We determine the residential retail control from the expenditure set out in Table 3.7, using an econometric modelling approach to set our allowance. The residential retail draft determination does not include any of our allowed pension deficit recovery costs. These costs have been wholly allocated to wholesale controls.

**Table 3.7: Expenditure, residential retail, 2020-25 (£ million, nominal)**

| | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 | Total |
|---|---|---|---|---|---|---|
| Residential retail | 17.4 | 17.4 | 17.4 | 17.4 | 17.4 | 87.2 |
| Company view | 15.9 | 16.1 | 16.3 | 16.5 | 16.6 | 81.5 |

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. There will be an end-of-period true-up based on the actual number of connected households.

## 3.7 Direct procurement for customers

We set out in our PR19 methodology that we expect company business plans to consider direct procurement for customers where this is likely to deliver the greatest value for customers. Direct procurement for customers promotes innovation and resilience by allowing new participants to bring fresh ideas and approaches to the delivery of key projects. Companies were to consider direct procurement for customers for discrete, large-scale enhancement projects expected to cost over £100 million, based on whole-life totex.

There is sufficient evidence that South East Water has a number of potential schemes which would be suitable for delivery by way of a direct procurement for customers process.

We expect that both the proposed New Arlington Reservoir and Broad Oak Reservoir, or similar sized alternative schemes, to be progressed through a direct procurement for customers process should they be confirmed, while we accept the Bewl-Darwell Transfer and Aylesford Newsprint water treatment works scheme are both likely to offer greater value for customers if delivered through a traditional in-house procurement process.

We expect South East Water to undertake further work to review detailed costs and commitments to ensure delivery of all schemes is via the most efficient route, and to re-assess delivery via a direct procurement for customers process if there are significant changes to their schemes or their value for money assessments, to ensure that customers continue to receive the best value.

Under direct procurement for customers the need to create regulatory mechanisms to manage uncertainty as a result of change is recognised. If a change in external factors dictates that a scheme no longer demonstrates value for money through direct procurement for customers, a scheme may pass from direct procurement for customers back to a traditional in-house procurement process.

We discuss the uncertainty mechanism further in ’Delivering customer value in large projects’.

# 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 4.4.

## 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 and water network plus), 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. 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 payments from PR14 through revenue adjustments in 2020-25.
- 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.
- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments. It will include income from connection charges and infrastructure charges. This does not necessarily agree to the total grants and contributions deducted from totex, as only the income relating to the price control is included here.
- Non-price control income – income from charges excluded from the price controls. For example, this includes bulk supplies, standpipes, unmeasured cattle

troughs, and other services. We deduct the forecast income from these charges from the allowed revenue, because costs relating to these charges are included in the calculation of allowed revenue.

- 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 East 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 6.

We explain how we calculate PAYG, RCV run-off and the allowed return on cost of 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 | Total | Company view - total |
|---|---|---|---|---|
| Pay as you go | 73.2 | 448.3 | 521.4 | 601.3 |
| RCV run-off | 16.8 | 216.4 | 233.3 | 238.0 |
| Return on capital | 11.4 | 169.8 | 181.2 | 201.1 |
| Revenue adjustments for PR14 reconciliations | 0.0 | 13.7 | 13.7 | 16.5 |
| Tax | 0.7 | 12.5 | 13.3 | 14.7 |
| Grants and contributions (price control) | 0.0 | 57.8 | 57.8 | 62.7 |
| Deduct non-price control income | -0.1 | -5.3 | -5.5 | -5.5 |
| Revenue re-profiling | 0.0 | 0.2 | 0.2 | 0.0 |
| Final allowed revenues | 102.0 | 913.3 | 1,015.3 | 1,128.9 |

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'South East Water - Allowed revenue appendix' in Tables 1.1 to Table 1.2.

## 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.
- Net margin on wholesale and retail activities – this is calculated based on the wholesale revenue applicable to residential retail customers, plus the retail cost to serve, with a net margin applied. Net margins are calculated excluding any adjustments to residential retail (see Table 4.2 below) – the full calculation is set out in our financial models.
- Our methodology set out an early view of the retail margin that applies for the retail price controls. This was used by South East Water in its business plan and is unchanged in our draft determination.

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

**Table 4.2: Retail margins (nominal price base)**

| | 2020-25 | Company view 2020-25 |
|---|---|---|
| Total wholesale revenue - nominal (£ million) | 1,052.2 | 1,167.2 |
| Proportion of wholesale revenue allocated to residential (%) | 77.69% | 77.69% |
| Residential retail costs (£ million) | 87.2 | 81.5 |
| Total retail costs (£ million) | 904.7 | 988.2 |
| Residential retail net margin (%) | 1.00% | 1.00% |
| Residential retail net margin (£ million) | 9.1 | 10.0 |
| Residential retail adjustments (£ million) | -0.8 | 0.2 |
| Residential retail revenue (£ million) | 95.5 | 94.9 |

Note: retail revenue is the sum of the net margin, retail costs, and adjustments. Company view may not sum as this may include other adjustments.
Note: the proportion of wholesale revenue allocated to residential customers is provided by the company in the business plan tables. This is provided for each wholesale control separately, so although we have used the same proportions for each control as the company, our interventions on costs in each control mean that the combined proportion is slightly different.

We set out the calculation of residential retail revenue on an annual basis in the 'South East Water - Allowed revenue appendix' in Table 1.3.

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

Our totex cost allowances are sufficient to meet an efficient company's operating and capital expenditure. Companies recover this expenditure either in period from current customers using PAYG or add it to the RCV and recover from future generations of customers using the RCV run- off rates. Consistent with our methodology, we assess how each company's choice of PAYG and RCV run-off rates reflect 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 the 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

We calculate total PAYG totex for each year of each wholesale price control based on the totex allowance for each year multiplied by the relevant PAYG rate for that year. To this we add allowed pension deficit recovery costs to derive total PAYG revenue.

We summarise in Table 4.3 the average PAYG rates across 2020-25 for each wholesale control, and the calculation of total PAYG revenue. The PAYG rates shown in the table are a weighted average across the five years 2020-25, the annual PAYG revenue and PAYG rates for each wholesale control are shown in the 'South East Water - Allowed revenue appendix', Tables 2.1 to 2.2.

To PAYG totex 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 | Total | Company view - Total |
|---|---|---|---|---|
| Totex allowance (£ million) | 115.3 | 694.6 | 809.8 | 944.3 |
| Draft determination PAYG rate(%) | 61.3% | 62.4% | 62.2% | |
| Pay as you go totex (£ million) | 70.7 | 433.3 | 504.0 | 585.0 |
| Pension deficit recovery cost (£ million) | 2.5 | 15.0 | 17.5 | 16.4 |
| Total pay as you go (£ million) | 73.2 | 448.3 | 521.4 | 601.3 |
| Company plan PAYG rate (%) | 61.3% | 62.0% | | 61.9% |

South East Water's approach to PAYG rates is to recover in each year an amount equivalent to operating costs plus infrastructure renewal costs. We accept the

approach taken by the company and have applied a technical intervention 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. We set out how we apply the technical intervention in 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our draft determinations.

Our view of efficient totex is lower than the company's plan and contains a lower proportion of capital expenditure than the company proposed. Therefore, using South East 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. The company proposes an increase to PAYG rates of on average 3.4% across the water resources and water network plus wholesale controls in relation to a notional financeability constraint. The company provides sufficient evidence to support the increase in PAYG rates and we are not intervening further on PAYG rates on the basis of financeability. We discuss our financeability assessment in section 5.4 Financeability.

## Opening RCV adjustments

As part of the business plan South East Water proposed allocations of the RCV for Water Resources price control based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale control and water resources control in accordance with the proportions proposed by South East 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 4.4: Opening RCV, 1 April 2020 (£ million)**

| | Water resources | Water network plus |
|---|---|---|
| RCV – 31 March 2020 | 1,375.7 | |
| % of RCV allocated by control | 5.00% | 95.00% |
| RCV – 31 March 2020 | 68.8 | 1,306.9 |
| Midnight adjustments to RCV | -2.3 | -44.3 |
| Midnight adjustments relating to operating leases | 0.5 | 2.0 |
| Opening RCV – 1 April 2020 (before fast-track reward) | 66.9 | 1,264.6 |

## 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 East Water's business plan incorporates the early view cost of capital for the wholesale price controls of 3.30% - CPIH deflated (2.30% - RPI deflated). We have updated our view of the cost of capital for the wholesale price controls to 3.08% – CPIH deflated (2.08% – RPI deflated). We set out the basis for the updated view in the 'Cost of capital technical appendix'. We have used our updated cost of capital in this draft determination.

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 totex that is added to the RCV, will be indexed to CPIH. Table 4.5 and Table 4.6 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. Totex that is added 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). This results in a return on capital for each wholesale control over the period 2015-20 as set out in Table 4.7.

### Table 4.5: Opening RCV by wholesale control for each component of RCV, 1 April 2020 (£ million)

| | Water resources | Water network plus | Total |
|---|---|---|---|
| RPI inflated RCV | 33.5 | 632.3 | 665.8 |
| CPIH inflated RCV | 33.5 | 632.3 | 665.8 |
| Other adjustments | - | - | - |
| Total RCV | 66.9 | 1,264.6 | 1,331.5 |

### Table 4.6: Closing RCV by wholesale control for each component of RCV, 31 March 2025 (£ million)

| | Water resources | Water network plus | Total |
|---|---|---|---|
| RPI inflated RCV | 29.8 | 560.1 | 590.0 |
| CPIH inflated RCV | 28.4 | 535.5 | 563.9 |
| Post 2020 investment | 37.9 | 241.8 | 279.7 |
| Other adjustments | - | - | - |
| Total RCV | 96.2 | 1,337.4 | 1,433.6 |

### Table 4.7: Return on capital by wholesale control for each component of RCV, 2020-25 (£ million)

| | Water resources | Water network plus | Total |
|---|---|---|---|
| RPI inflated RCV | 3.3 | 62.1 | 65.4 |
| CPIH inflated RCV | 4.8 | 89.7 | 94.5 |
| Post 2020 investment | 3.3 | 18.0 | 21.4 |
| Other adjustments | - | - | - |
| Total return on capital | 11.4 | 169.8 | 181.2 |
| Company view – total return on capital | 12.7 | 188.3 | 201.1 |

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 East Water - Allowed revenue appendix' in Tables 3.1 to 3.8 and 4.1 to 4.2.

## 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 control for post 1 April 2020 investment. Table 4.8 sets out the resultant RCV run-off revenue for each component of RCV for each wholesale control.

### Table 4.8: RCV run-off on the RCV (5 year) (£ million)

| | Water resources | Water network plus | Total |
|---|---|---|---|
| CPIH inflated RCV | 5.0 | 96.8 | 101.9 |
| RPI inflated RCV | 5.2 | 100.2 | 105.3 |
| Post 2020 investment | 6.7 | 19.4 | 26.1 |
| Total RCV run-off | 16.8 | 216.4 | 233.3 |
| Company view – total RCV run-off | 17.6 | 220.4 | 238.0 |

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 East Water's RCV run-off rates are based on average lives for assets within each wholesale control. We accept South East Water's RCV run-off rates for the draft determination. However, the interventions to allowed totex change the post-2020 investment added to RCV and therefore the total RCV run-off shown in Table 4.8. 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 4.9: RCV run-off rates for each wholesale control (5 year)

| | Water resources | Water network plus |
|---|---|---|
| Original company plan (%) | 3.97% | 3.28% |
| Draft determination (%) | 3.91% | 3.28% |

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.

Where there are different RCV run-off rates for post-2020 investment RCV, or CPIH inflated RCV for water network plus control, compared to other elements of RCV, interventions to allowed totex and to PAYG rates may result in average RCV run-off rates varying between the company plan and the draft determination. The annual rates for each wholesale control are set out in the 'South East Water - Allowed revenue appendix' in Table 5.1 to Table 5.2.

## 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 East Water - Accounting for past delivery actions and interventions' provides a detailed explanation of all policy interventions we are making in the models. Table 4.10 summarises our interventions. Table 4.11 sets out the resulting adjustments to revenue and the RCV. The 'South East 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 4.4.

We are publishing the results of the reconciliation of the service incentive mechanism for all companies alongside the draft determinations for slow track and significant scrutiny companies in the 'Accounting for past delivery technical appendix'.

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 use final 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 2020 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 were to be more significant, we would expect companies to take measures to smooth the impact for their customers. The new PR19 mechanism to share benefits with customers from unexpected high outcome delivery incentive payments in a year will not apply to PR14 outcome delivery incentives. Instead the PR14 protection that caps the impact across the five years 2015-20 will 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 4.10: Reconciliation of PR14 incentives, interventions (2017-18 prices, unless otherwise stated)

| Incentive | Intervention(s) |
|---|---|
| Outcome delivery incentives | We are intervening to move the actual and forecast outperformance payments for performance commitment F2 (properties at risk of low pressure), from 'end of period outcome delivery incentive revenue adjustments' to 'end of period outcome delivery incentive RCV adjustments.'<br>This is because the 'Revised corrigenda for South East Water for PR14' (originally published 13 February 2015, subsequently republished on 2 November 2016) states that the 'Form of reward/penalty' is 'Adjustment to RCV'.<br>This minor intervention increases the total net performance revenue underperformance payment at the end of the 2015-20 period from - £0.066 million to - £0.084 million and decreases the RCV adjustment at the end of the 2015-20 period from - £0.624 million to - £0.605 million. |
| Residential retail revenue | We are including a figure of 3.74% for the 'Materiality threshold for financing adjustment - Discount Rate' in line with the 'PR14 reconciliation rulebook'.<br>This minor intervention does not result in any changes to the total residential retail revenue payment at the end of the 2015-2020 period which remains at £0.167 million because the materiality threshold is not exceeded. |
| Wholesale revenue forecasting incentive mechanism | No interventions required. |
| Totex | No interventions required. |
| Land sales | No interventions required. |
| Service incentive mechanism | We are intervening to set South East Water's service incentive mechanism adjustment to - 0.75% of household retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to - £0.863 million in total revenue over the period. This decreases revenue relative to the company's estimate of the mechanism's impact. |
| PR09 blind year adjustments | No interventions required. |

**Table 4.11: Reconciliation of PR14 incentives, 2020-25 (£ million, 2017-18 prices)**

| Incentive | RCV adjustments | | Revenue adjustments | |
|---|---|---|---|---|
| | Company view | Ofwat view | Company view | Ofwat view |
| Outcome delivery incentives | -0.6 | -0.6 | -0.1 | -0.1 |
| Residential retail revenue | N/A | N/A | 0.2 | 0.2 |
| Wholesale revenue forecasting incentive mechanism | N/A | N/A | 21.0 | 21.0 |
| Totex | -22.5 | -22.6 | -5.6 | -5.6 |
| Land sales | 0.6 | 0.6 | N/A | N/A |
| Service incentive mechanism | N/A | N/A | 0.0 | -0.9 |
| PR09 blind year adjustments | -24.1 | -24.1 | 0.2 | 0.2 |
| Water trading | N/A | N/A | 0.0 | 0.0 |
| Total | -46.6 | -46.6 | 15.6 | 14.7 |
| Total post profiling | N/A | N/A | 16.7 | 15.7 |

Note: Total post profiling is the total revenue over the period, taking account of the time value of money and the company's choices of how it wishes to apply revenue adjustments either in the first year or spread over a number of years.

These reconciliations are based on data from the 1 April company submissions. We will update these reconciliations to reflect the July data submissions for the final determinations.

## 4.4 Other allowed revenue

Other components of allowed revenue are:

- 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.
- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments. It will include income from connection charges and infrastructure charges.

- Non-price control income – this forecast income is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control.

**Table 4.12: Calculation of other allowed revenue (£ million)**

| | Water resources | Water network plus | Total | Company view - total |
|---|---|---|---|---|
| Tax | 0.7 | 12.5 | 13.3 | 14.7 |
| Grants and contributions (price control) | 0.0 | 57.8 | 57.8 | 62.7 |
| Deduct non-price control income | -0.1 | -5.3 | -5.5 | -5.5 |

## Taxation

We calculate a tax allowance reflecting the corporation tax that the company expects to pay in 2020-25. We calculate the tax allowance using our 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 East 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 changes to capital allowances. 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 East Water assumes 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 East Water to identify this as part of its representations on the draft determination.

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

| | Water resources | Water network plus | Total | Company view - total |
|---|---|---|---|---|
| Tax | 0.7 | 12.5 | 13.2 | 14.7 |

## 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 receivable 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. We use this calculation of grants and contributions receivable from developers to ensure that the amounts billed to water customers correctly reflect only that share of any new development spend which should be borne by them.

The recovery rates are calculated as follows:

- For water new developments we use the rate implied by the South East Water business plan which is 59.4%,
- For the additional allowance that we included for the 'Zonal strategy' expenditure for Ashford and Basingstoke growth we have assumed a recovery rate of 75%. Our rationale for using a rate which is in excess of the company average rate is that by doing this we will ensure that this additional cost allowance for a significant number of new homes does not disproportionally impact on existing customers' bills; and
- For water new connections we use a rate of 100% based on our understanding of historical practice in the industry and is broadly supported by company business plans.

Table 4.14 shows our assumed amounts of grants and contributions. Our view of new developments and new connections expenditure is lower than South East Water's forecast. The reasons behind the differences in our view of 'Base expenditure' are set out above in the 'Cost allowances' section. 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 use the company view of the associated income and assume that this represents 100% of the costs. In modelling our draft determinations we assume

that all diversions income is inside the price control. For the final determinations we consider that we should make a distinction between diversions that are inside or outside the scope of section 185 of the Water Industry Act 1991. Works that are outside the scope of section 185 are, for example, works under the New Roads and Street Works Act 1991 or those associated with High Speed 2. We are yet to have sufficient data to be able to distinguish section 185 diversions from non-section 185 diversions. For the final determination we will assume diversions expenditure is inside the price control unless it relates to non-section 185 diversions. Where companies forecast diversions works outside of section 185 then they should provide details of the income relating to this, on an annual basis, in the data request that accompanies the draft determination. This should be returned with the representations to the draft determination.

**Table 4.14: Calculation of other allowed revenue (£ million) – Grants and contributions**

| | Water resources | Water network plus | Total | Company view - total |
|---|---|---|---|---|
| Grants and contributions | 0.0 | 57.8 | 57.8 | 62.7 |

## Non-price control income

Non-price control income is income from the excluded charges defined in licence condition B. For example, it includes bulk supplies, standpipes, unmeasured cattle troughs, and other services. This is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control.

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

**Table 4.15: Calculation of other allowed revenue (£ million) – Non-price control income**

| | Water resources | Water network plus | Total | Company view - total |
|---|---|---|---|---|
| Non-price control income | -0.1 | -5.3 | -5.5 | -5.5 |

Note: negative numbers represent a deduction from the allowed revenue.

## Uncertainty mechanisms

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

# 5 Assurance, returns and financeability

This section sets out the accountability the company's Board has demonstrated for delivering its plan, the accuracy and consistency of the information within the plan and company proposals for aligning the interests of company management and investors with its customers. We summarise South East Water's response to our actions on securing confidence and assurance, including South East Water's proposals in response to our 'Putting the sector in balance' position statement. We comment on the possible range of returns for the notional financial structure. We comment also on the financeability of the draft determination and any adjustments that we have made to the bill profile.

## 5.1 Assurance

The PR19 methodology set out that stakeholders should have confidence in the information presented in business plans. We set expectations that:

- the data and information presented in the plan must be subject to good assurance processes to ensure it is consistent and accurate; and
- a company's full Board should own, be accountable for and provide assurance of the business plan.

In the initial assessment of plans, we identified three actions in relation to South East Water's data tables and financial model. South East Water has satisfactorily responded to all of these actions as set out in its response to our actions on securing confidence and assurance.

We had no concerns with South East Water's forward-looking Board assurance statements and therefore set no actions in the initial assessment of plans.

## 5.2 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. In summary, we expect that:

- company dividend policies for their actual financial structures and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers[3];
- companies with high levels of gearing will share financing gains from high gearing with customers; and
- companies provide assurance and supporting evidence to demonstrate their long term financial resilience and management of financial risks for the actual financial structure.

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

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

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

| Issue | Our assessment |
|---|---|
| Gearing outperformance benefit sharing | South East Water has set out a commitment to reduce its gearing from 78% (as at 31 March 2018) to 75% during 2020 to 2025 through equity injection. It says that its shareholders have confirmed availability of funding which the company expects to be introduced prior to 30 September 2019. The company has included our default mechanism in its business plan. |
| Voluntary sharing mechanisms | South East Water has not proposed any voluntary sharing mechanism. However, the company does propose company contributions to a hardship fund for customers who may be experiencing short-term or medium-term financial hardship and affordability issues caused through circumstances such as bereavement, job loss or sickness. |
| Dividend policy for 2020-25 | South East Water has committed to the expectations 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 around 2.3% for 2020-25. It has confirmed that when setting dividend payments, it will take into account its performance against pre-set stretching outcome delivery incentive targets and its performance outside of the outcome delivery incentive framework, including other commitments made to customers.<br>The company has committed to reporting on its dividend policy annually, and that it will be transparent and held to account for the judgments it has made.<br>However insufficient detail has been provided on which obligations or commitments to customers will be considered and how it will affect dividend payments. We expect the company to be transparent in this area, to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We also expect the company to demonstrate that its dividend policy takes account of performance in delivery against the final determination along with wider |

[3] We explain more fully our expectations in the 'Aligning risk and return technical appendix' that accompanies this draft determination.

| Issue | Our assessment |
|---|---|
| | obligations. 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 East Water says it strongly believes that the current executive pay arrangements (for 2015-20) reflects an appropriate balance between outcomes customers have told the company are important and financial performance, and that it intends to use a similar approach in the design of the 2020-25 arrangements.<br>The company has told us it has revised its policy from that submitted in the business plan and has indicated that at a high level it will now consist of the following principles:<br>• the award will be made based on performance in five business areas: 1) customer satisfaction, 2) operational performance, 3) delivery of responsible business commitments, 4) financial performance and 5) individual objectives.<br>• both schemes (i.e. annual bonus and long-term bonus) will be based on the following principles c. 60%+ on operational targets including customer service and personal performance and c. 40% on financial performance.<br>• both schemes following similar principles ensuring they are focused on short-term and long-term performance.<br>• the annual bonus being more explicit on setting targets and assigning reward in relation to responsible business commitments including broader stakeholder considerations including employee engagement, community impacts, environmental performance etc.<br>• the long-term bonus having a portion of the award deferred in a manner similar to the existing long term incentive plan in 2015-20.<br>• performance thresholds typically set using targets set out in the regulatory determination, but in some cases the target being triggered at a level that outperforms the final determination.<br>• the remuneration committee having the responsibility for designing, monitoring and reporting executive pay in accordance with its terms of reference.<br>• a commitment to report the details of the performance related pay schemes, including the awards made, transparently in the annual report.<br>The company has stated that the detailed design of the executive remuneration scheme will only be determined after the publication of the final determination.<br>We understand that there remain some details to be finalised, for example the finalisation and approval of the policy including the details of the underlying metrics and associated weightings for both the annual and long term bonus schemes. The policy, once finalised and approved, demonstrates the company's commitment to move in the direction of the expectations set out in 'Putting the sector in balance'. We expect South East Water to provide an update on this in response to its draft determination.<br>We expect South East Water to demonstrate that its policy on performance related executive pay demonstrates a substantial link to stretching performance delivery for customers through 2020-25. We expect the company and its remuneration committee to ensure executives 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 in its annual performance report. |

| Issue | Our assessment |
|---|---|
| Financial resilience of the company's actual financial structure | South East Water has set out a commitment to reduce its gearing from 78% (as at 31 March 2018) to 75% during 2020 to 2025 through equity injection. It says that its shareholders have confirmed availability of funding which the company expects to be introduced prior to 30 September 2019.<br>South East Water considers this will provide sufficient headroom to its covenant limits.<br>South East Water says that it has secured the financing needed to refinance £312 million of debt maturing in September 2019 and that it does not expect to raise a material amount of debt during 2020-25. The company says that its financial resilience approach for the period includes a flexible dividend policy, improved debt maturity profiles and the maintenance of substantial reserve liquidity facilities.<br>South East Water considers that its targeting of a Baa2/BBB credit rating is appropriate and that it will be able to achieve the metrics required for its target credit rating. It considers that under plausible financial stress scenarios it would be able to maintain an investment grade rating.<br>In an updated statement, South East Water's Board sets out that it remains confident that the company's business plan and response to our initial assessment will, over the next control period and in the long term, enable the company to fulfil its statutory and licence obligations and remain resilient - operationally, financially and corporately.<br>The assessment of financial resilience does not take account of our interventions in South East Water's business plan, which includes, for example, our updated view of the cost of capital, our assessment of efficient costs and our assessment of outcome delivery incentives. Each company is responsible for ensuring its capital and financial structure allows it to maintain financial resilience over the short and the long term and so we expect South East Water to take account of these issues in its commentary on its long term financial resilience in response to our draft determination, taking account of the reasonably foreseeable range of plausible outcomes of the final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.<br>In doing so, we expect South East Water to have particular regard to its high level of gearing and target credit rating, which is one notch below the target credit rating it has used for its assessment of financeability for the notional capital structure.<br>South East Water has committed to demonstrating that its assessment of financial resilience extends beyond 2025 in its next Long Term Viability Statement. In its future reporting, we expect South East Water to apply suitably robust stress tests in its long term viability statements in 2020-25. |

## 5.3 Return on regulatory equity

The PR19 methodology sets out that we expect 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 expect 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 P10/P90 confidence limit values[4].

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 allowed 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[5]. 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.

Table 5.2 sets out the annual average RoRE ranges in South East Water's updated PR19 business plan submission, and the values in our draft determination. The base RoRE in our draft determination reflects our updated cost of equity. The RoRE ranges reflect our interventions outlined below, and other interventions we are making as part of our draft determination.

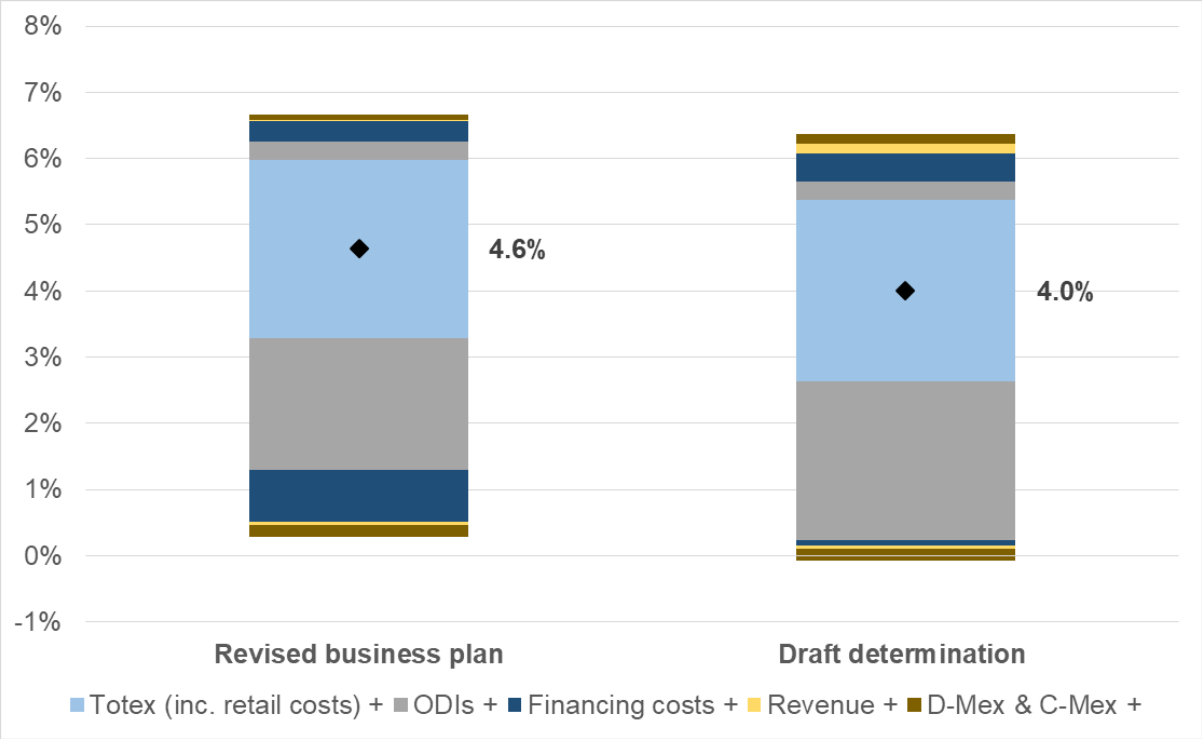
[4] P90 is the performance threshold at which there is only a 10% chance of outturn performance being better. P10 is the performance threshold at which there is only a 10% chance of outturn performance being worse.

[5] RPI is the retail price index; CPIH is the consumer price index including owner-occupiers' housing costs; both are published by the Office for National Statistics.

### Table 5.2: South East Water RoRE ranges

| | Updated Business plan (Apr 19) | | Draft determination ranges reflecting our interventions | |
|---|---|---|---|---|
| Base RoRE | 4.6% | | 4.0% | |
| **Risk ranges** | **Lower bound** | **Upper bound** | **Lower bound** | **Upper bound** |
| Totex | -1.14% | 0.84% | -1.16% | 0.86% |
| Outcome delivery incentives | -1.99% | 0.28% | -2.40% | 0.27% |
| Financing costs | -0.79% | 0.79% | -0.08% | 0.30% |
| Retail costs | -0.21% | 0.21% | -0.21% | 0.21% |
| D-Mex & C-Mex | -0.18% | 0.09% | -0.18% | 0.10% |
| Revenues (includes Retail) | -0.05% | 0.01% | -0.05% | 0.01% |
| **Total** | **-4.36%** | **2.22%** | **-4.08%** | **1.75%** |

### Figure 5.1: RoRE ranges



The draft determination risk ranges shown in Table 5.2 and Figure 5.1 reflect two interventions we are making with respect to values in South East Water's updated business plan:

- For the draft determination we are intervening to reduce South East Water's financing risk range associated with the cost of new debt to 100 bps on the upside and 25 bps on the downside. This intervention is consistent with the PR19 methodology. It is also consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt, and the company has not provided convincing evidence for a higher risk range. However, as set out in the 'Aligning risk and return technical appendix', we are considering the assessment of debt cost risk further for the final determination.
- We are intervening to align the RoRE risk ranges for outcome delivery incentives shown in Table 5.2, Figure 5.1, and in the PR19 financial model with the RoRE risk range values for outcome delivery incentives set out in section 2 (Outcomes). The revised values reflect our interventions on outcome delivery incentives under the Outcomes Framework which seek to take account of covariance of performance on individual outcome delivery incentives in the presentation of the overall outcome delivery incentive range.

In all other areas we have retained South East Water's proposed RoRE range, which produces a negative skew overall, driven primarily by outcome delivery incentives and totex. Our view is that an efficient company should be able to achieve the base equity return on the notional structure. We expect South East Water to consider necessary revisions to its overall RoRE range in response to the draft determination.

## 5.4 Financeability

We interpret our financing duty as a duty to secure that an efficient company can finance the proper carrying out of 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 a 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 PR19 methodology requires companies to provide Board assurance that the business plan is financeable on both the notional and their actual capital structures. Our methodology requires companies to provide evidence to support these statements, including evidence supporting the target credit rating and that this is supported by the financial ratios that underpin the plan. South East Water's Board has provided assurance that, based on the assumptions in its business plan, both notional and actual capital structures remain financeable in the long-term, and that key financial ratios are at a level that retain sufficient headroom to maintain an investment grade credit rating ensuring that resilience and customers' interests are maintained in the short and long term. South East Water proposes an increase of 3.4 per cent to PAYG rates to solve a financeability constraint. The company sets out

that financial ratios are not consistent with the target credit rating for the notional company structure excluding this adjustment and provides a third party assessment which supports this.

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 financeability assessment uses a suite of financial metrics based on those used in the financial markets and by the credit rating agencies. We retain South East Water's increase to PAYG rates in our assessment of notional financeability and we consider the adjustment in necessary for the financial ratios to be consistent with maintaining sufficient headroom to the minimum investment credit rating. Based on the financial ratios from the financial model including the 3.4 per cent uplift to PAYG rates as proposed by the company alongside evidence in the business plan, we consider that South East Water's draft determination is financeable for the notional structure.

The results for key financial ratios including the increase to PAYG rates are set out below. Key financial ratios for the notional company structure in our draft determination are broadly in line with to the ratios set out by South East Water in its business plan.

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

| | Business plan | Draft determinations |
|---|---|---|
| Gearing | 60.02% | 59.74% |
| Interest cover | 3.92 | 3.93 |
| Adjusted cash interest cover ratio (ACICR) | 2.26 | 2.22 |
| Funds from operations (FFO)/Net debt | 9.86% | 9.64% |
| Dividend cover | 2.26 | 1.38 |
| Retained cash flow (RCF)/Net debt | 8.06% | 7.54% |
| Return on capital employed (RoCE) | 4.63% | 4.23% |
| The basis of the calculation of the ratios is set out in the PR19 methodology<br>**Net debt** represents borrowings less cash and excludes any pension deficit liabilities.<br>**FFO** is cash flow from operational activities and excludes movements in working capital.<br>**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 totex and therefore the mix of operating and capital expenditure. The adjusted cash interest cover ratio is affected by South East Water's accounting policy of capitalising part of its infrastructure renewal expenditure and the allocation of this to PAYG revenue as this is treated as fast money within the calculation of the ratio. We discuss the impact of fast money on financial ratios in the 'Aligning risk and return technical appendix'.

We are not intervening in RCV run-off rates, however interventions to allowed totex and to PAYG rates will change the level of post-2020 additions to RCV. This may affect the average RCV run-off rates and result in movements between the original plan and the draft determination shown in Table 5.4. The reduction in expenditure means that the RCV will now increase by a smaller amount than set out in the original business plan.

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

| | PAYG | RCV run-off | RCV growth |
|---|---|---|---|
| Company plan | 61.9% | 3.33% | 11.31% |
| Draft determinations | 62.2% | 3.32% | 7.67% |

South East Water is responsible for the financeability and long term financial resilience of its actual structure. The company has proposed to reduce its gearing by directly injecting equity. We comment further on the financial resilience of the company's actual structure in Table 5.1.

We expect companies to provide further Board assurance that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.

# 6 Affordability and bill profile

## 6.1 Bill profile

South East Water's bill acceptability research, undertaken in spring 2019 with a representative sample of 1,000 customers, outlines that 82% of customers find its real terms water bill to be acceptable, this drops to 50% for the combined bill. The company does not test nominal bills. The company's research displays some weaknesses, in particular the question on real terms acceptability does not acknowledge that inflation will be added to the bill shown to customers. The company and customer challenge group liaised on the content and design of the survey and the company appears to have adapted the exercise in light of customer challenge group comments. The customer challenge group seem to be generally satisfied with the exercise.

Taking account of its acceptability results and its testing of bill profile preferences, in the round South East Water provides sufficient evidence on the acceptability of its bills. However, we note the company does not test nominal bills and that, as outlined above, its research contains weaknesses in terms of its presentation of information on bills.

South East Water undertakes engagement on long-term bills with a sample of 1,000 customers through a mixture of online and in-home interviews. The research tests customer views on whether bills should fall now and rise later, rise now or fall later or remain stable - 82% of customers support a stable bill over the 2020-30 period, which is what the company proposes to deliver.

The average bill profile put forward by South East Water provides a bill that remains broadly flat in the 2020-25 period, with a total reduction of 0.6%. Our amended profile increases this to a reduction of 9.7%. The table below sets out the difference in bills between the company's submission and our amended draft determination figures. We adjust the bill profile so that it provides an initial drop in 2020-21, followed by flat bills. We consider this an improvement on the company's proposal as it delivers the stable real terms bill that customers support as well as a reduction that will improve affordability.

**Table 6.1: Bills in real terms**

| | 2019-20 | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 |
|---|---|---|---|---|---|---|
| Company plan | £205 | £204 | £204 | £204 | £204 | £204 |
| Bill profile – before re-profiling | £205 | £186 | £186 | £185 | £184 | £183 |
| Draft determinations | £205 | £185 | £185 | £185 | £185 | £185 |

In its business plan, the company sets out its intention to increase bills by around 2% in the 2025-30 period. The company's research indicates this proposal is acceptable to 79% of customers.

**Table 6.2: Long term bills**

| | 2020-25 | 2025-30 |
|---|---|---|
| Company view of plan | £204 | £208 |

## 6.2 Help for customers who are struggling to pay

Our draft determinations for South East Water will deliver a real terms reduction to the average bill between 2020 and 2025.

In addition, South East Water commits to:

- increase the number of customers that receive support through social tariffs and WaterSure from around 30,000 in 2019-20 to 75,000 by 2024-25;
- increase its cross-subsidy to £5.50 to deliver its ambition on social tariffs;
- introduce new 'passport' scheme to allow third parties to accept customers directly onto their affordability schemes;
- create a vulnerability mapping tool that will combine external vulnerability risk factor data with priority services register data to improve customer outcomes; and
- report on its performance in relation to its vulnerability strategy annually through its website, and refresh the entire strategy every two years.

South East Water has six bespoke performance commitments on affordability and vulnerability, which will require it to:

- improve customer views of value for money;
- increase the number of customers it reaches through its affordability support schemes;
- improve satisfaction among customers receiving vulnerability assistance in general and during outage incidents;
- improve satisfaction among customers who are experience payment difficulties; and
- maintain high stakeholder satisfaction with the non-financial support it offers to customers.

Companies will be reporting their performance against the Priority Services Register common performance commitment and their bespoke affordability and vulnerability performance commitments 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 in 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.

## 6.3 Total revenue allowances and k factors

Table 6.3 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 6.3: Allowed revenue by year (£ million, 2017-18 prices)**

| | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 | Total |
|---|---|---|---|---|---|---|
| Water resources | 19.4 | 19.8 | 20.4 | 21.0 | 21.4 | 102.0 |
| Water network plus | 178.9 | 180.9 | 182.7 | 184.4 | 186.5 | 913.3 |
| Residential retail | 18.0 | 17.7 | 17.4 | 17.1 | 16.8 | 86.8 |
| Total | 216.3 | 218.3 | 220.4 | 222.5 | 224.6 | 1,102.1 |

The water resources and water 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 6.4 sets out the K factors in each year for each of these two 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 6.4: 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 | 19.4 | 0.00% | 2.19% | 3.05% | 2.99% | 1.87% |
| Water network plus | 178.4 | 0.00% | 1.16% | 1.03% | 1.00% | 1.13% |

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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