

December 2019

PR19 final determinations

Hafren Dyfrdwy – Aligning risk and return final decisions

PR19 final determinations: Hafren Dyfrdwy – Aligning risk and return final decisions

In our [draft determinations](#) we published the ‘Aligning risk and return actions and interventions’, the ‘Securing long-term resilience actions and interventions’ and the ‘Securing confidence and assurance actions and interventions’ document for each company. This set out the required and advised actions in our initial assessment of plans, a summary of the company’s response to the action, our assessment of the company’s response, and any further interventions we made as part of the draft determination.

This document sets out the decisions we are making for the final determination in response to representations received from companies on our draft determinations and changes for the final determination that are not resulting from representations received. We set out our response to thematic representations and representations from other stakeholders within the ‘Aligning risk and return technical appendix’ and the ‘Allowed return on capital technical appendix’. Our ‘Allowed revenue appendix’ for the company is published alongside this document. These documents are intended to be fully consistent. In the event of any inconsistency, the other documents listed above take precedence over this document.

Table 1 below sets out the action/intervention reference, our assessment and rationale for the draft determination, a summary of the company representation, our assessment and rationale for the final determination and our decisions for the final determination.

Table 2 sets out any further decisions that are not resulting from an action and/or representation which we are making as part of the final determination.

Each action has a unique reference. The prefix ‘HDD’ denotes the company Hafren Dyfrdwy. The central acronym references the test area where the action has been identified, please see the ‘Glossary’ for a key to these acronyms. Actions whose numbers are preceded with an ‘A’ denote required actions and actions whose numbers are preceded with a ‘B’ denote advised actions. Draft determination interventions not resulting from an initial assessment of plans action are preceded with a ‘C’ and new interventions for the final determination not related to a previous action are preceded with a ‘D.’ For all other documents related to the Hafren Dyfrdwy draft determination, please see the [final determinations webpage](#).

Table 1: Hafren Dyfrdwy - Representations in response to the draft determination

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	HDD.RR.A1	The company proposes a net margin of 1.20% for <5ML/yr users despite operating in a non-contested market segment. The company should limit its margin to the PR16 1.0% cap, or provide compelling evidence why this is not appropriate.	No intervention required. Hafren Dyfrdwy has provided sufficient further narrative that the net margin cap is below 1.0% overall, and this is consistent with PR16.	No representation made.	No change for the final determination.	N/A
Risk and return	HDD.RR.A2	The company should amend its assessment of revenue variance in its RoRE risk analysis or provide convincing evidence that its exposure to revenue variation is as	No intervention required. Whilst Hafren Dyfrdwy’s downside RoRE risk range for revenue remains relatively large in comparison with	No representation made.	No change for the final determination.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		wide as its analysis suggests, particularly given the PR19 methodology.	other companies, the company provides sufficient justification for its view.			
Risk and return	HDD.RR.A3	The company should set out the steps taken and the assurance obtained by the board in order to assess financeability of the business plan.	No intervention required. Hafren Dyfrdwy has completed the action. The company has clearly set out the steps taken by the Board in providing its assurance statement on financeability.	No representation made.	No change for the final determination.	N/A
Risk and return	HDD.RR.A4	The company should provide clarity with appropriate reasoning for the credit ratings targeted for both the notional and its actual company structure and should set out further evidence that the key financial ratios are consistent with the target credit ratings including threshold levels for the ratios.	No intervention required. Hafren Dyfrdwy has completed the action. The company sets out it has used its own model to assess financeability which it has reconciled to the Ofwat model, showing where differences occur and providing a full suite of financial ratios that support the target credit rating.	No representation made.	No change for the final determination.	N/A
Risk and return	HDD.RR.A5	The company should ensure it is using the correct assumptions for the notional company including the cost of debt in assessing the key financial ratios. The RPI rate of inflation should be used to translate the nominal cost of debt to real for index linked debt.	No intervention required. Hafren Dyfrdwy has completed the action. The company has amended its assumptions to be consistent with our expectations.	No representation made.	No change for the final determination.	N/A
Risk and return	HDD.RR.A6	The company should provide further evidence to support the calculation of PAYG and RCV run-off rates and demonstrate that the starting point for the rates are consistent with the approach set out in the business plan.	Intervention required. Hafren Dyfrdwy has provided further evidence to support the calculation of PAYG and RCV run off rates. There is convincing evidence that PAYG rates are appropriate. The company has set out sufficient evidence to support applying a backward-looking approach to RCV run-off rates based on the amount customers were funding at PR14.	Representation made. The company accepts the intervention and has reflected the revised RCV run-off rates within the financial model.	No change for the final determination.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			<p>This looks at historical rates for assets that were transferred to the company at the time of the border variation due to the mismatch between the value of the assets and the RCV transferred at that time. The company applies a reduction to RCV run-off rates to maintain affordability and the commitments made regarding bills at the time of the border variation.</p> <p>However, there is insufficient evidence to support the increase in RCV run off rates for the wastewater network plus control from those in the original business plan in September 2018.</p> <p>We are intervening in RCV run off rates for the wastewater network plus control to reduce rates to the level proposed in the original business plan.</p>			
Risk and return	HDD.RR.A7	The company should provide further evidence that the proposed adjustments to PAYG and RCV run-off rates achieve the objectives set out in the business plan and are consistent with the commitments set out in the NAV application.	<p>Intervention required.</p> <p>Hafren Dyfrdwy's RCV run-off rates are initially based on the depreciation rate for each wholesale control. However, to maintain affordability and the commitments made at the time of the border variation (NAV), the company has reduced RCV run off rates.</p> <p>We accept the final rates for all wholesale controls except for the wastewater network plus control which has increased from the original submission. Hafren Dyfrdwy has not provided sufficient evidence for the increase.</p> <p>As per action HDD.RR.A6</p>	Representation made as per HDD.RR.A6	No change for the final determination.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	HDD.RR.A8	The company should set out the steps taken to address the concerns raised by the Customer Challenge Group and CCWater in relation to the final bill profile for water customers, providing further evidence that the final bill profile set out in the business plan is consistent with customer preferences for all customers or revise the bill increase for water only customers in line the profile presented to customers.	<p>No intervention required.</p> <p>Hafren Dyfrdwy provides evidence of profiles representing various PAYG and RCV run-off rates, modelling the NAV commitments, smoothing bills and balancing bills between services and presented two profile to customers including the bill profile proposed in the revised business plan.</p> <p>The company has provided further evidence of customer support for the increase it is proposing for water only customers. Combined with the testing for water and wastewater customers, the evidence summarises the level of support for the bill increase for all customers, although we note in our response to action HDD.AV.A1 set out in 'Hafren Dyfrdwy Addressing affordability and vulnerability actions and interventions' that bill acceptability is not high. We note our interventions to Hafren Dyfrdwy results in a lower bill, with a 2.4% reduction in draft determination, and so do not require further evidence of acceptability from Hafren Dyfrdwy</p> <p>The customer challenge group provided a report on the revised business plan and were satisfied the research approach was carried out in accordance with best practice.</p>	No representation made.	No change for the final determination.	N/A
Risk and return	HDD.RR.B1	The company should explain in further detail how its risk management and risk mitigation measures are taken into account in its RoRE assessment	<p>No intervention required.</p> <p>The company has responded satisfactorily to the advised action.</p>	Representation made.	No change for the final determination.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	HDD.RR.C1	Hafren Dyfrdwy's approach to setting PAYG rates is to recover operating expenditure and infrastructure renewal expenses. The application of efficient totex in our draft determination has resulted in a change to the mix of opex and capex in totex to the extent that PAYG rates are no longer aligned with Hafren Dyfrdwy's stated approach.	We are making a technical intervention to align PAYG rates to Hafren Dyfrdwy's stated approach of recovering operating expenditure for each year for each wholesale control.	Representation made. The company accepts the intervention.	No change for the final determination.	N/A
Risk and return	HDD.RR.C3	We are intervening to reduce the quantum of Hafren Dyfrdwy's downside Totex risk by £5 million. Whilst Hafren Dyfrdwy refers to challenging efficiency assumptions for the wholesale price controls in its plan, the base cost allowance totals we have determined (set out in section 3.2) are higher than the company's view.	We are intervening to reduce the quantum of the downside totex risk by £5 million over the period 2020-25.	No representation made.	Change for the final determination.	See HDD.RR.D4.
Risk and return	HDD.RR.C4	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. This approach seeks to take account of covariance in performance on individual outcome delivery incentives.	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework.	Representation made. Hafren Dyfrdwy provides updated views on RoRE risk ranges for ODIs in its representation on the draft determination. It considers there should be revised penalty rates for pollution, leakage, supply interruptions and low pressure and a revised penalty collar for water supply interruptions.	Change for the final determination.	In our final determination for Hafren Dyfrdwy we: <ul style="list-style-type: none"> adjust the water supply interruptions 2024-25 level taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company and reduce the ODI underperformance rate to be symmetrical with the outperformance rate. introduce a sharing mechanism for Hafren Dyfrdwy if total net ODI underperformance payments are more than 3% of return on regulatory equity in any year, to mitigate the risk of excessive downside from large exposure on some individual ODIs and due to the lack of long-term historical data and the small size of the company.

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						<ul style="list-style-type: none"> make changes on mains repair to take account of historical levels of performance and the implications of leakage reduction levels for mains repairs; amend the deadband on the compliance risk index, reducing the risk of underperformance payments in the last three years of 2020-25. <p>Further information is provided in the Hafren Dyfrdwy company specific appendix.</p>
Risk and return	HDD.RR.C5	We expect companies to update their RoRE risk range analysis in response to the draft determinations.	We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the 'Aligning risk and return technical appendix' that accompanies our draft determination and 'Technical appendix 3: aligning risk and return' published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the company, taking account of the company's reported level of actual performance delivered in 2015-19 and taking account of the steps it is	<p>Representation made.</p> <p>Hafren Dyfrdwy considers that the level of challenge in the draft determination means it would have a RoRE range significantly biased towards the downside. It provides updated views on its RoRE risk ranges, including for C-Mex and financing costs, based on its represented plan in response to the draft determination.</p> <p>We present our assessment of the RoRE risk range provided by the company in its representation in the 'Hafren Dyfrdwy company specific appendix' which presents a downward skew to the overall risk range relating to totex risk and outcome delivery incentives.</p>	Change for the final determination.	See HDD.RR.D4.

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			already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk.			
Securing confidence and assurance	HDD.CA.A3	<p>On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <p>clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and</p> <p>commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends.</p> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our 'Putting the sector in balance' position statement.</p>	<p>No intervention but further action needed by Hafren Dyfrdwy.</p> <p>We expect the company to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our 'Putting the sector in balance' position statement. We expect the company to respond to this issue in its response to our draft determination.</p> <p>We expect the company to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies.</p>	<p>Representations made.</p> <p>The company in its response to the draft determination confirms that when determining the appropriate level of dividend, the Board will have regard to its performance across its obligations and outcome delivery incentives. Targets are set based on forecast upper quartile performance, linked to the standards of performance set in the final determination. The company has detailed the specific obligations and commitments to customers that will be considered. The company confirms that dividends can be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid.</p>	<p>Change for the final determination.</p> <p>We have updated our assessment of the reasonable base dividend for water companies in 2020-25 as set out in the 'Aligning risk and return technical appendix'.</p>	<p>We expect Hafren Dyfrdwy to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25, to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return: technical appendix'.</p>
Securing confidence and assurance	HDD.CA.A4	<p>On executive pay the company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <p>providing full details and commitment to publish, including all performance metrics, the executive pay policy for 2020-25;</p> <p>visibility and evidence of substantial linkage of executive remuneration to delivery to customers;</p>	<p>No intervention but further action needed by Hafren Dyfrdwy.</p> <p>There remain some details to be finalised, for example details of the underlying metrics that the company is proposing to use in the annual bonus and how they will deliver stretching performance.</p> <p>Once finalised we expect Hafren Dyfrdwy to provide an update in its response to the draft determination to demonstrate that it is committed to</p>	<p>Representation made.</p> <p>In its response the company has provided some additional information to that previously provided. It states the performance commitments to be included with the bonus scheme will be finalised once the final determinations has been received</p> <p>The company states that the remuneration framework is designed to deliver stretching performance, and will follow a defined process annually. For</p>	<p>Change for the final determination.</p> <p>Hafren Dyfrdwy states that it is committed to meet the expectations set out in our 'Putting the sector in balance: position statement'. However, based on our calculations, the overall percentage of alignment of incentives to customers falls short of the 60% we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'. We</p>	<p>We expect Hafren Dyfrdwy to be transparent when explaining and reporting the application of its performance related executive pay policy over 2020-25, to demonstrate how it exhibits a substantial alignment to the delivery of service for customers and meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		<p>clear explanation of stretching targets and how they will be applied; clear explanation of how the policy will be rigorously applied and monitored; and</p> <p>commitment to report how changes, including the underlying reasons, are signalled to customers.</p> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.</p>	<p>meet the expectations we have set out in 'Putting the sector in balance' position statement. In addition, we expect the company to demonstrate how the policy and its implementation maintain alignment with the service delivered to the customers of Hafren Dyfrdwy in the short and the long term.</p> <p>We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.</p> <p>We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.</p>	<p>2020-25 this process will start once the final determination is published and the performance commitment targets are known and accepted.</p> <p>In setting annual targets, the remuneration committee will consider a range of factors including:</p> <ul style="list-style-type: none"> • the targets • the level of historical performance: and • comparative performance within the sector 	<p>therefore consider that there is scope for the company to improve this position.</p>	
Securing long-term resilience	HDD.LR.C1	<p>The Board assurance on actual and notional financeability and financial resilience in the revised business plan was provided on the basis of the assumptions made in the business plan, prior to any interventions we have made in the draft determination and our updated view of the cost of capital. There is evidence of further downward pressure on the cost of capital in very recent market data</p>	<p>We expect companies to provide further Board assurance, in their responses to the draft determination, 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</p>	<p>Representation made.</p> <p>Hafren Dyfrdwy set out that its board reviewed and challenged the financial ratios resulting from the draft determination, in particular the impact of a further WACC reduction on the long-term resilience of the actual company. Having done so the company's board is satisfied that the draft determination would be financeable at the appointee level for both the notional and actual</p>	<p>No change for the final determination.</p> <p>We consider that our determinations are financeable for an efficient company with a notional capital structure. However, there is also a need for companies to ensure that they are financially resilient under their actual structures. We have not accepted all of the company's representations and the</p>	<p>We will closely monitor changes in levels of the company's gearing, other key financial metrics and the certificates that it provides to us in relation to whether it can maintain financial ratios which are consistent with an investment grade credit rating during 2020-25 to test that that its financial resilience is being maintained.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		which will be considered for our final determination.	capital in very recent market data as we discuss in the 'Allowed return on capital technical appendix'.	<p>financing company. The Board statement also covers the impact of the potential 37bps WACC reduction on financeability.</p> <p>Hafren Dyfrdwy also obtained third party assurance that the draft determination WACC results in financial ratios, at the appointee level, consistent with Hafren Dyfrdwy's target credit rating of BBB+/Baa1 for AMP7 under the notional and actual structure.</p> <p>Hafren Dyfrdwy has committed to assess its financial resilience beyond 2025 in its next long term viability statement.</p>	<p>allowed return is lower in the final determination reflecting market expectations on the cost of finance. The company is responsible for maintaining its financial resilience and so the company may need to take steps to maintain its financial resilience in 2020-25, including to reduce its proposed base dividend yield for 2020-25 in the context of the allowed return in the final determination.</p>	<p>In its future reporting, we expect the company to explain clearly in its long term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks.</p>

Table 2: Hafren Dyfrdwy - Changes to the draft determination that are not in response to an action or representation

Test area	Actions/ intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
Allowed return on capital	HDD.RR.D1	<p>We have revised our assessment of the allowed return drawing on market data up at 30 September 2019 and taking account of revisions to our approach following our assessment of representations.</p> <p>We have revised our assessment of the required retail margin deduction down from 0.11% to 0.04%, reflecting our view that the double-counted component of return in the household retail margin has reduced since PR14.</p> <p>We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.</p>	<p>The sector allowed return on capital for the appointee price controls in our final determinations is 2.96% – CPIH deflated (1.96% – RPI deflated), 23 basis points lower than in the draft determination.</p> <p>The sector allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated), 16 basis points lower than in the draft determination.</p>
Gearing outperformance sharing mechanism	HDD.RR.D2	<p>In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return technical appendix'.</p>	<p>We have changed the trigger from a fixed trigger of 70% in the draft determination to a glide path which will start at 74% for the year 2020-21 and will reduce by 1% each year, ending at 70% for the year 2024-25 in the final determination.</p>
Financeability	HDD.RR.D3	<p>We consider that Hafren Dyfrdwy's final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.</p>	<p>We discuss our assessment of financeability in the 'Hafren Dyfrdwy final determination' and the basis on which we consider Hafren Dyfrdwy's final determination to be financeable on the basis of the notional capital structure.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	HDD.RR.D4	<p>We have revised our approach to assessing RoRE risk ranges for five of the risk areas set out in the PR19 methodology to take account of changes we have made in our final determinations to address concerns raised by companies on the overall level of stretch in our draft determinations, and evidence on past performance that we have observed in the sector. Our approaches are set out in the 'Aligning risk and return technical appendix' and the risk ranges for Hafren Dyfrdwy are set out in the 'Hafren Dyfrdwy final determination'.</p> <p>Taking account of changes in our final determination, the RoRE risk ranges at P10 and P90 confidence limits in our final determinations are, in most cases, more symmetrical than the risk ranges represented by companies. Our view of risk ranges also indicates more scope for outperforming companies to earn higher returns, but also for underperforming companies to receive lower returns.</p>	<p>The final determination risk range reflects the following interventions that we make for all companies:</p> <ul style="list-style-type: none"> • The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination. • The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt. • The ODI risk range has been determined under our Outcomes Framework. • The C-MeX risk range is calculated as 12% upside and 12% downside of residential retail revenue, reflecting the cap and collar limits for this incentive. • The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.
Financial Risk Assessment – Uncertainty Mechanisms	HDD.RR.D5	<p>We are including a PR24 reconciliation mechanism for business rates in our final determination for Hafren Dyfrdwy along with all other companies because:</p> <ul style="list-style-type: none"> • There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material. 	<p>In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst receiving appropriate protection against material cost increases. Conversely, customers will receive a benefit if outturn costs are lower than the allowance</p>

Test area	Actions/ intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
		<ul style="list-style-type: none">Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices.	levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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