December 2019

PR19 final determinations

PR19 final determinations: SES Water final determination

Ofwat

www.ofwat.gov.uk

PR19 final determinations: SES Water final determination

About this document

This document supports the 'Notification of the final determination of price controls for SES Water' and sets out further details about the final determination price control, service and incentive package for SES Water for 2020 to 2025. All figures in this document are in 2017-18 prices except where otherwise stated.

The final determination documentation sets out:

- the outcomes for SES Water to deliver;
- the allowed revenue that SES 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.

This final determination is in accordance with our PR19 methodology (as updated), our statutory duties[1] and the UK Government's statement of strategic priorities and objectives for Ofwat[2]. 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.

Our final determination carefully considers all of the representations we received from companies and stakeholders on our draft determination and takes account of the most up-to-date information available where appropriate. Where appropriate, we explicitly set out our response to points and issues raised by respondents. Where information was provided late and we have not been able to take full account of this in the final determination, this is explicitly stated.

There are five appendices to this document on cost efficiency, outcomes performance, past delivery, allowed revenue and, where relevant, additional information. For all documents related to the SES Water final determination, please see the final determinations webpage. Where we reference other documents related to our final determinations we do not include the 'PR19 final determinations' prefix to the document title, for documents relating to our initial assessment of plans or draft determinations the full document title is referenced.

If SES Water accepts our 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.

[1] See the 'Policy summary' for more information.
[2] See 'UK Government priorities and our 2019 price review final determinations' for more information.

Contents

Amendment	Date
Page 31 – Amendment made to figure, from £3.9 million to £6.9 million for water network plus. Page 35, Table 3.7 – Amendments made to figures. • Grants and contributions before the deduction of income offset (£m) Network plus – Water amended from £21.5m to £20.5m. • Net allowed totex subject to cost sharing reconciliation Network plus – Water amended from £183.1m to £184.2m.	18 May 2020

1 Summary

The water sector faces challenges of climate change, a growing population and increasing customer expectations, while improving affordability of an essential service. The 2019 price review (PR19) enables and incentivises companies to address these challenges both in 2020-25 period and longer term.

To do this the sector needs to innovate and challenge itself to deliver better performance for customers and the environment. Companies need to engage and work with customers and other companies, the supply chain and with other stakeholders.

Our PR19 methodology sets out a framework for companies to address the challenges facing the sector with a particular focus on improved service, affordability, increased resilience and greater innovation. We published our draft determination for SES Water on 18 July 2019, based on our detailed review of the revised plans submitted to us on 1 April 2019. The company and a number of stakeholders provided representation responses on our draft determination on 30 August 2019.

Our final determination carefully considers all of the representations we received from companies and stakeholders on our draft determination and takes account of the most up-to-date information available where appropriate. We consider the changes we have made in our final determination are in line with our statutory duties.

1.1 What our final determination includes

This section sets out the overall shape of our final determination for SES Water, covering the customer bill profile, costs, outcomes for customers and allowed revenues. More detail is provided in the following sections of this document.

Bill profile

Our final determination for SES Water will cut average bills by 15.6% in real terms in the 2020-25 period compared to the company's proposed 7.1% reduction. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in April 2019, our draft determination and the final determination. Average bills are lower than proposed by SES Water, reflecting our view of efficient costs and a reduction in the allowed return. Further details on bills are set out in section 6.

Table 2.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan (April resubmission)	£194	£182	£182	£182	£182	£180
Draft determination	£194	£161	£161	£161	£161	£161
Final determination	£194	£178	£174	£171	£167	£164

Costs

Our final determination allows wholesale totex of £254.6 million. This is:

- £29.8 million higher than in our draft determination and
- £12.7 million lower than stated in the company's representation on our draft determination.

Our final determination allows SES Water £39.8 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £19.1 million for new meter installations
- £11.2 million for supply-demand balance improvements
- £6.4 million for improving resilience

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

Outcomes for customers

Our final determination package includes a full set of performance commitments, specifying the minimum level of service that SES Water must commit to deliver for customers and the environment under this price review. These sit alongside the company's statutory and licence requirements. Each performance commitment also has a financial or reputational incentive to hold the company to account for delivery of these commitments.

Further details of key performance commitments are set out in table 1.2 below and in section 2.

Table 1.2: Key performance commitments for SES Water

Area	Measure
Key common performance commitments	• At least 15% reduction in annual level of leakage by 2024-25 from PR14 levels3. • 6.6% reduction in per capita consumption by 2024-25 • A level of 5 minutes for 2024-25 for water supply interruptions
Bespoke performance commitments	• 15% increase in the share of customer contacts, including enquiries and complaints that are resolved on first contact by 2024-25 • 71% increase in the number of projects completed to deliver the outcomes associated with the Water Industry National Environment Programme (WINEP) by 2024-25
Overall incentive package	Overall, the likely range of returns from outcome delivery incentive package in our final determination equates to a return on regulatory equity range of - 1.01% (P10) to + 1.28 % (P90).

Note that the calculations behind these numbers are outlined in the 'SES Water - Outcomes performance commitment appendix'.

Allowed revenues

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

[3] Please note that the figures in the tables of the 'SES 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 and show a 12.4% reduction from 2019-20 baseline levels on a three-year average basis.

Table 2.3: Allowed revenue, 2020-25 (£ million)

	Water Resources	Network plus - water	Wholesale total	Residential retail	Total
Company view of allowed revenue (£m)	26.1	252.4	278.5	34.7	313.1
Final allowed revenues (£m)	26.9	249.4	276.3	25.2	301.5

Note that 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 'Allowed return on capital technical appendix', we are updating our assessment of the allowed return on capital for SES Water's final determination. The allowed return is 2.96% (on a CPIH basis, 1.96% on a RPI basis) at the appointee level. After adjustment for the retail margin, the allowed return on capital for the wholesale price controls is 2.92% (on a CPIH basis, 1.92% on a RPI basis), a reduction of 0.16 percentage points from our draft determination, reflecting our assessment of market evidence. The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

SES Water's Regulatory Capital Value (RCV) growth in 2020-25 is 7.6% and 66.1% of its RCV will be indexed to CPIH in 2025. We bring forward £2 million of revenue from future periods. We consider that SES Water's final determination is financeable on the basis of the notional structure, based on a reasonable allowed return on capital and revenue advances through PAYG adjustments. The determination is sufficient to deliver its obligations and commitments to customers. Further detail on our assessment of financeability is set out in section 5.

Putting the sector in balance

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. SES Water commits to meeting the expectations set out in our 'Putting the sector in balance position statement'.

The company confirmed it would implement our default gearing outperformance mechanism within its business plan. Under its actual financial structure, SES Water expects to maintain gearing below the level that would trigger sharing payments under the gearing outperformance sharing mechanism in 2020-25.

To meet our expectations, the company will need to demonstrate to stakeholders that dividends and performance related executive pay policies are substantially aligned to its performance for customers.

In the 'Putting the sector in balance' position statement we also encouraged companies to adopt a voluntary sharing mechanism, particularly where, for example, companies outperform our cost of debt assumptions. SES Water has not proposed any voluntary sharing mechanism. However, the company is increasing the number of customers it supports who are in financial hardship to 25,000 from 19,000 in their original plan, at no additional cost to customers.

We provide further detail on these issues in section 7.

1.2 Representations on the draft determination

All companies and stakeholders were invited to make representations on our draft determinations by 30 August 2019. More detail about the issues raised in the representations by the company and our consideration of those issues can be found elsewhere in this document, the technical appendices and other documents published alongside our final determinations. Table 1.4 highlights the key points made by SES Water in its representation together with any further submissions after that date and a summary of our response to each of those points.

Table 2.4: Company representation

Key point in SES Water representation	Summary of our response
SES Water has removed £8.7 million of expenditure from its plan. It states that the SES Water Board 'is unable to accept the feasibility of the draft determination position given that this would result in a significant overspend to strive to meet our stretching performance commitments.' It maintains its cost adjustment claims for: leakage reduction £17.4 million, network resilience £8.9 million and wholesale electricity usage £10.5 million.	We allow £8.6 million for leakage to reflect the proportion of the reduction occurring beyond the forecast upper quartile threshold, see section 3.3 and 'Cost efficiency technical appendix' for more detail. We allow £6.4 million for network resilience to complete its provision of a second source of supply for its customers. We consider the proposal for service reservoir by-pass work to be capital maintenance and make no additional allowance for it, see section 3.3 for more detail.

	We allow £10.5 million for SES Water's wholesale electricity usage, see section 3.2 for more detail.
SES Water has reduced its residential retail costs by £2.1 million however it maintains that our approach to assessing retail costs is "fundamentally flawed". It strongly disagrees with using forward-looking efficiency challenge in our retail models and what it sees as the poor fit of our retail models based on the high spread of efficiency scores. It has proposed a number of improvements to our retail modelling approach which it states will improve the strength and validity of the models.	SES Water has the least efficient forward-looking residential retail costs in the industry and we consider that it needs to make significant improvements to its efficiency. Using a forward-looking efficiency challenge (i.e., business plans) is appropriate in retail, which is a sector that has been transforming since the introduction of the separate retail controls in 2015. We consider our position on this is robust and do not make further changes. On reviewing our models for final determination we have decided to reduce the weight placed on our 'bottom-up' models, which have a relatively large spread, and increase the weight on our 'top down' models, which have lower spread. We consider this addresses SES Water's modelling point, see section 3.5 for more detail.
SES Water challenges our current definition of upper quartile performance for leakage since it believes it should be upper quartile and so be funded for improvement.	We expect an efficient company to achieve its stretching performance commitments from our base allowance. We make an enhancement allowance for leakage reduction only where the company's performance commitment goes beyond the industry upper quartile leakage performance. For SES Water 55% of its improvement in leakage is beyond the upper quartile threshold. Therefore in our final determination, we make a partial allowance for SES Water at final determination based on the proportion of the company's proposed leakage reduction that will take it beyond the upper quartile threshold. See section 3.3 and 'Cost efficiency technical appendix' for more detail.
The company proposes an alternative approach to setting the outcome delivery incentive rate for its water softening performance commitment. It argues that the underperformance incentive should be scaled by how much the water softening level is missed and this should be a running average over quarterly measurement periods. It confirms acceptance of the water softening level by the London Borough of Sutton.	We partly adopt the company's representation approach but consider that a fortnight is a more appropriate measurement period. This decreases the incentive rates but drives the right behaviours by the company to continue softening in the event of a failed test. We also specify a uniform testing regime to encourage these behaviours, see section 2 and 'SES Water - Delivering outcomes for customers additional information appendix'.
The company disagrees with our disallowance of its requested company-specific uplift. However it indicates that it is financeable without the uplift if its representation is accepted. It raises a concern about the wider effects of the declining allowed return on capital and strongly cautions against a further fall at final determination. It says it has proactively set out to achieve a balance between net debt and equity to reduce its gearing ahead of the 2020-25 period.	We maintain our position to not allow the requested company-specific uplift to cost of debt as the company has not supplied sufficiently convincing evidence that its customers supported funding its proposed uplift or that there are benefits that compensate customers for the additional cost. We use an allowed return on capital based on updated market evidence, as set out in our 'Allowed return on capital technical appendix'.

	We have carefully considered all of our duties, in particular our financing functions and consumer protection duties, and are satisfied that our final determination fulfils our duties in the round. Our assessment of notional financeability for the final determination is made in the context of changes made to the draft determination in our final determination. We consider the company's final determination is financeable on the basis of the notional structure based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure the company will be in a position to deliver its obligations and commitments to customers. It is the company's responsibility to maintain financial resilience under its actual financial structure and it must bear the risks associated with its choice of capital and financing structure.

We also received representations on SES Water's draft determination from other stakeholders as shown in table 1.5, which shows a summary of our response to representations that are relevant to the company. Representations from some other stakeholders relate to all companies and are described in the relevant technical appendices. More detail about the issues raised in the representations by stakeholders can be found elsewhere in this document, the technical appendices and other documents published alongside our final determinations.

Table 2.5: Stakeholder representations

Stakeholder representations	Summary of our response
The Consumer Council for Water's (CCWater) representation response is broadly supportive of the SES Water's draft determination in particular the revised performance commitments for per capita consumption and leakage. It raises concerns with the bill profile proposed at draft determination as it considers that a smooth bill profile is preferable for customers.	We adjust our bill profiles at final determination to a smoother profile.

1.3 Key changes from the draft determination

Our final determination carefully considers the representations we received from companies and stakeholders on our draft determinations on 30 August 2019. It also takes account of the most up-to-date information available where appropriate. Changes to overall revenue and costs allowances are set out in table 1.6.

Table 1.6: Difference in cost and revenue allowance final to draft determination

	Draft determination	Final determination
Allowed revenues (£m, 2017-18 CPIH deflated)	274.5	301.5
Wholesale cost allowance[1] (£m, 2017-18 CPIH deflated)	224.8	254.6
Retail cost allowance (£m, nominal)	26.7	27.8
Wholesale allowed return[2] (% - CPIH basis)	3.08%	2.92%

[1] Note that we include pension deficit recovery costs in the wholesale cost allowances we present in table 1.6 above and in table 3.1 later in this document. At the draft determination we published cost allowances excluding pension deficit recovery costs. The numbers we show here as the draft determination allowances can be calculated by adding the pension deficit recovery costs from draft determination table 3.2 to draft determination table 3.1 total allowances. Our decisions on individual elements of the totex allowance are set out in section 3.
[2] The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

Significant changes from the draft determination for SES Water are:

- Following representations from SES Water we make allowances for enhancement resilience (£6.4 million) and electricity costs (£10.5 million) after considering additional evidence provided.
- We revise our leakage assessment approach and make an allowance of £8.6 million.
- We make a £1.7 million upward adjustment to our base allowance for water network plus. The adjustment is due to a relatively high forecast of population growth in 2020-25 in the company's supply area.
- On mains repairs, we make changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction levels for mains repairs. We amend the underperformance payment rate on mains repairs for all companies to industry average which will reduce the downside risk for the company.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the outcome delivery incentive underperformance rate to be symmetrical with its outperformance rate.
- Taking account of company representations, we revise our approach to determine the mix of operating and capital expenditure to take better account of the nature of our decisions on cost allowances. We apply the updated approach in our technical intervention to PAYG rates.

- We increase pay as you go (PAYG) rates to bring forward allowed revenue by £2 million to address a notional financeability constraint. This compares to £1 million in the draft determination.
- We reflect SES Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission.
- We revise SES Water's average bill profile from a large reduction upfront followed by flat real term bills, to have a smaller reduction upfront, followed by a gradually falling real bill over 2020 – 25.
- We update the gearing outperformance sharing mechanism to introduce a glidepath to the gearing level that the triggers sharing payments as set out in the 'Aligning risk and return technical appendix'.

2 Outcomes

Key changes from the draft determination

The key changes made to the outcomes elements of the draft determination are:

- We amend levels on mains repairs by making changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction levels for mains repairs. We also amend the underperformance payment rate on mains repairs for all companies to industry average to provide a more balanced spread of incentives and risks.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the underperformance rate to be symmetrical with its outperformance rate. Together these two changes provide a more balanced spread of incentives and risks on water supply interruptions
- We amend the deadband on the Compliance Risk Index (which measures compliance with the Drinking Water Inspectorate's (DWI's) water quality standards) to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25 period. This allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde, which has been overturned by the High Court and also aligns with the median level of company performance.

Throughout PR19, we have been asking companies to:

- make stretching performance commitments to their customers;
- have stronger incentives to deliver on their commitments; and
- better reflect resilience in their commitments

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 are the reputational and financial incentives that companies have, to deliver on their performance commitments to customers. They 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 incentive payments 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 company's current performance is about average for the sector. It is a lower quartile performing company on service incentive mechanism however its score has improved in 2018-19. In 2018-19 it failed its supply interruptions performance commitment but met its leakage performance commitment.

In its September 2018 business plan, the company set appropriately stretching service levels, for example for supply interruptions and leakage. However, the evidence the company provided on outcome delivery incentives was insufficient. The company did not present enough evidence for customer support for outperformance payments, its rates had a narrow evidence base and many of these rates were outliers including on asset health where rates were not strong enough to protect customers from poor performance. SES Water did not carry out any further customer engagement activity before its April revised business plan and therefore did not provide additional evidence on customer support. We have some concerns with how the company has set the outcome delivery incentive rates based on the use of a single customer valuation and this appears to be biased upwards by an extreme value. Therefore, our draft determination reduced some outperformance payments (for example leakage and supply interruptions) and removed others (for example per capita consumption and mains repairs).

The company makes few representations to its draft determination. It argues that it should receive enhancement funding for leakage and also raises issues with the new water softening performance commitment we introduced at draft determination.

SES Water is the only water company with statutory obligations to soften water supplied from its five treatment works (two at specified levels of calcium and three with unspecified levels of calcium). At draft determination, we introduced a performance commitment to ensure that the company was incentivised to deliver its water softening obligations. The definition specified that if the company's proposed average weekly hardness at any of the five sites is above the target level to any extent, it will face a fixed underperformance payment for each site.

The company argues in its representation that the incentive should be scaled by how much the level is missed and that this should be a running average over quarterly measurement periods. It confirms acceptance of the level by the relevant local authority (the London Borough of Sutton). The Consumer Council for Water supports a running average. We consider that a fortnight is a more appropriate measurement period to take into account the issues that the company raises relating to water hardness variability over time and is not unduly onerous on the company to have different reporting obligations on water quality. This decreases the incentive rates but drives the right behaviours by the company to continue softening in the event of a failed test. We also specify a uniform testing regime to further encourage these behaviours.

In addition, we are amending some common performance commitment levels and outcome delivery incentive rates in line with our industry wide decisions. For example, we are reducing the stretch on supply interruptions performance levels since we are taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We are also reducing the stretch for mains repairs to ensure levels take account of historical levels of performance and the implications of leakage reduction levels for mains repairs. In addition, we are reducing the underperformance payments for mains repairs and supply interruptions, as part of a sector-wide change to provide a balanced spread of risks and incentives.

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 expected 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 continued our assessment of customer engagement evidence following each company's submission of its representations to our draft determination in August 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.

In its September 2018 business plan, SES Water provided sufficient evidence to demonstrate elements of a high quality approach to customer engagement, such as using a range of data sources including 'business as usual' data. However, there were some areas of concern such as insufficient evidence of engaging with customers regarding their appetite for risk or use of comparative information to help customers make informed decisions. We could not see clearly how the results of customer engagement were reflected in its business plan (in relation to outcomes) and ongoing business operations.

Following our initial assessment of the plan, in its April 2019 revised business plan SES Water decided not to undertake new customer engagement on outcomes. Instead, the company commissioned a report which reviews outcome delivery incentive calculations, including triangulation[4] with more recent data sources. We were not able to validate the independence of the submitted report, however we welcomed the additional assurance it provides. We recognised that SES Water adopted suggestions from the report regarding outcome delivery incentives for a number of performance commitments. SES Water did not undertake new customer engagement in relation to customers' support for outperformance payments or long-term bill profiles. Although not requested, in the company's April 2019 revised

[4]Triangulation is the method used in averaging across multiple sources of research and data to set outcome delivery incentive rates.

business plan, SES Water undertook specific research about customers' views on paying a small company premium. We considered the results to be statistically robust and demonstrate customer support for the premium. However, we found evidence that the research approach led participants to understand that the premium amount is already included in current bills.

In its August 2019 representations to our draft determination, SES Water states that our draft determination 'does not reflect the priorities of our customers within the overall objectives publicised and pursued by Ofwat.' The company submits new customer engagement research with its representations to our draft determination. This focussed on customers' willingness to pay to protect 100% of households from the risk of supply failures and the magnitude of support for investing to reduce leakage and to do this through mains replacement.

We find that while the new research presented is statistically robust in terms of the sample size, we have concerns about the quality of the research. Namely, the extent to which the company educated its customers in relation to providing comparative or historical performance levels that would allow the customer to make a more informed decision. For example, the research provided no evidence that the customer was informed that the risk of supply failures (a bespoke performance commitment) is relatively low. Therefore, while we allow the company to reinstate this performance commitment, we do not allow outperformance payments. We also introduce a clause that states we will recover 50% of the allowed costs in addition to the delay underperformance rate if the company under delivers in the 2020-25 period and will not deliver the improvements in the 2025-30 period. This is because we consider that outcome delivery incentive rates for late delivery should compensate customers for the forgone benefit of not receiving the scheme on time

In relation to leakage, we do not find the research sufficient to change our outcome delivery incentive rate for our final determination. We ensure that the underperformance rate recovers enhancement funding if the company does not achieve the performance levels that its funding is granted for.

The company's customer challenge group submit representations in August 2019 to our draft determination in which it expresses concern that lower bills are being prioritised over service improvement that customers have expressed a preference for in the customer engagement research, such as reliability of supply and water quality. We have considered the outcomes of the company's customer engagement for all of the company's performance commitments. We have not made any trade-off between bill reduction and service improvement.

In relation to resilience the customer challenge group states that short- and long-term resilience is important to customers and expect SES Water to provide sufficient evidence to allow continuation of its dual supply programme. It submits specific representations on leakage and mains replacement, where it states that 'allowance of enhancement expenditure will support achievement of the highest stated customer priority'. We make increased enhancement cost allowances for both leakage reduction and resilience enhancement in our final determination. We explain these further in section 3.3 below.

On water softening the group agrees with a report commissioned by NERA Economic Consulting Group in which they state that the underperformance payment should be graduated and structured to allow for small fluctuations in the measure. The company makes a further representation on this (please see above in section 2 for more details of our assessment).

We set out in our PR19 methodology that we expect companies to reflect their customers' preferences in the levels they propose for performance commitment levels and outcome delivery incentives. We also expected companies to challenge the level of stretch in their performance commitments against a range of approaches (for example, against comparative and historical information). In our PR19 methodology we also expected companies to use customer valuations to set outcome delivery incentive rates and noted that we would compare these valuations and rates and challenge companies where appropriate. Therefore, when making our decisions, we have taken into account several factors in setting our final determination outcome delivery incentive rates including the quality of customer evidence provided. Our suite of final determination documents explains the rationale for our decisions, including the evidence used to inform our decisions.

2.2 Performance commitments and outcome delivery incentives

SES Water's performance commitments and outcome delivery incentives for the 2020-25 period are listed in table 2.2 and table 2.3. The full details of these performance commitments and outcome delivery incentives are set out in the 'SES Water - Outcomes performance commitment appendix'.

The key changes we are making in the final determination are set out in table 2.1[5] below. 'SES Water – Delivering outcomes for customers final decisions' sets out our final decisions in terms of changes to our draft determination for the company's

[5] Please note, table 2.1 focuses on policy changes and does not include changes made to correct errors in our draft determinations or changes made as a consequence of other amendments such as updating enhanced outcome delivery incentive rates for amendments to standard outcome delivery incentive rates using the same methodology and approach as at draft determinations.

performance commitments and outcome delivery incentives, having considered stakeholder and company representations to our draft determination.

Table 2.1: Summary of key changes to draft determinations on outcomes

Key changes
Increasing the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the underperformance rate to be symmetrical with its outperformance rate. Together these two changes provide a more balanced spread of incentives and risks on water supply interruptions.
Increasing the performance commitment levels for mains repairs by a reducing percentage, for all companies, in all years, reducing the stretch. The aim is to allow all companies the flexibility to deliver the step change in leakage reduction, allowing more flexibility in the earlier years to use proactive mains repairs to reduce leakage. We also amend the underperformance payment rate on mains repairs for all companies4 to industry average which will provide a more balanced spread of risks and incentives for the company.
We amend the deadband on the Compliance Risk Index to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25 period. This allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde, which has been overturned by the High Court and also aligns with the median level of company performance.
Amending the definition of the performance commitment in relation to water softening to measure performance on a fortnightly basis, which we consider is adequate to take into account the issues that the company raises relating to water hardness variability over time and is not unduly onerous on the company to have different reporting obligations on water quality. Moreover, we amend the definition to state that performance will be measured as the extent by which the water softening threshold is missed and with a target of zero. This will make the measure stable as it does not rely on absolute values of hardness limits. This approach also allows for the possibility of the Council revising its decision during the 2020-25 period, Furthermore, we include in the definition that the timing of the company's water hardness tests should represent a uniform regime over time and that this should be verified by an appropriate third party. In addition, we accept the company's proposal that underperformance payments that are scaled according to the amount by which the target has been missed and are normalised per mega litre supplied to reflect the number of customers served.
Amending the performance commitment definitions in relation to non-household void properties to ensure that in-period determinations take into account the financial consequences of any retail market mechanism which may be developed, for example, under the Market Performance Framework in the 2020-25 period.

Table 2.2: Summary of performance commitments: common performance commitments

Name of common performance commitment	Type of outcome delivery incentive			
	Financial			Reputational
	Under	Out	In-period	
Water quality compliance (CRI) [PR19SES_A.4]	X		X	
Water supply interruptions [PR19SES_A.1]	X	X	X	
Leakage [PR19SES_C.4]	X	X	X	
Per capita consumption [PR19SES_E.1]	X		X	
Mains repairs [PR19SES_A.2]	X		X	
Unplanned outage [PR19SES_C.3]	X		X	
Risk of severe restrictions in a drought [PR19SES_C.1]				X
Priority services for customers in vulnerable circumstances [PR19SES_B.5]				X
C-MeX: Customer measure of experience [PR19SES_D.2]	X	X	X	
D-MeX: Developer services measure of experience [PR19SES_D.3]	X	X	X	

Table 2.3: Summary of performance commitments: bespoke performance commitments

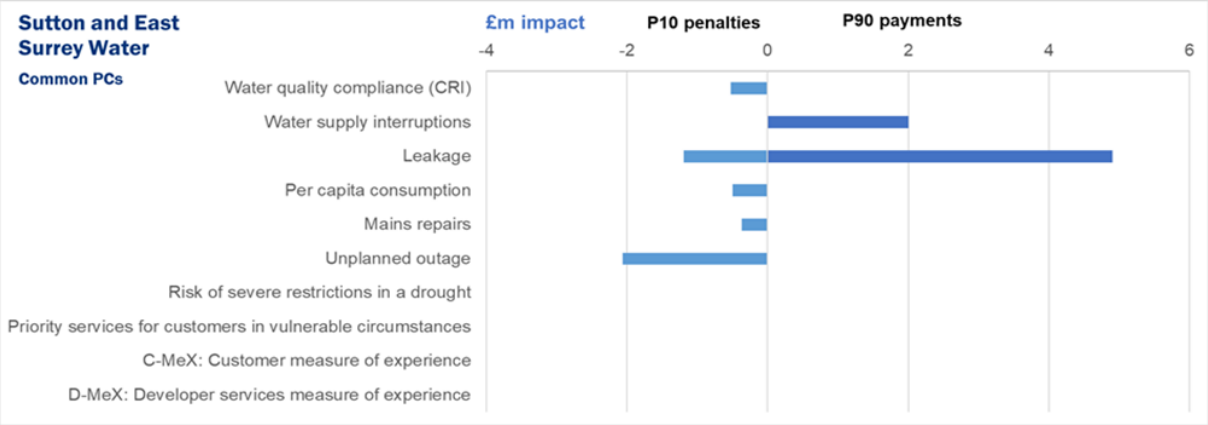
Name of bespoke performance commitment	Type of outcome delivery incentive				
	Financial				Reputational
	Under	Out	In-period	End of period	
Customer concerns about their water (taste, odour and discolouration contacts) [PR19SES_A.3]	X		X		
Supporting customers in financial hardship [PR19SES_B.1]	X		X		
Vulnerable support scheme awareness [PR19SES_B.2]					X
Vulnerable support scheme helpfulness [PR19SES_B.3]					X
Void properties [PR19SES_B.4]	X	X	X		
First contact resolution [PR19SES_D.1]	X		X		
Greenhouse gas emissions [PR19SES_E.2]	X		X		
Pollution incidents [PR19SES_E.3]					X
Abstraction incentive mechanism [PR19SES_E.4]					X
Land based improvement - biodiversity [PR19SES_E.5]					X
River based improvement - delivery of WINEP [PR19SES_E.6]	X		X		
Water Softening [PR19SES_A.5]	X		X		
Perception of value for money [PR19SES_B.6]					X
WINEP Delivery [PR19SES_NEP01]					X
Risk of supply failures [PR19SES_C.2]	X		X		

Figure 2.1 and figure 2.2 provide an indication of the financial value of each of SES Water's outcome delivery incentives (taking into account the impact of our final determination decisions) 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 outperformed to the P90 level. 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.

The figures cover common and bespoke commitments respectively. The estimates are based on the company's own view of the plausible bounds of performance submitted in April 2019 submission. Where we have changed service levels for performance commitments, we have amended these estimates so that the distance between the service level and estimate remains the same.

Our analysis has built on the estimates companies have provided, but there is a range of plausible estimates of what may happen in plausible worst case (P10) and plausible best case (P90). There is inherent uncertainty in forecasting these parameters and the figures presented should be seen as indicative of the likely range of financial impacts for each performance commitment.

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



P10 underperformance payments and P90 outperformance payments for C-Mex: Customer measure of experience and D-Mex: Developer services measure of experience are not shown in this figure but are shown in table 5.1 below.

Figure 2.2: Projected P10 underperformance payments and P90 outperformance payments for bespoke performance commitments over 2020-25 (£ million)

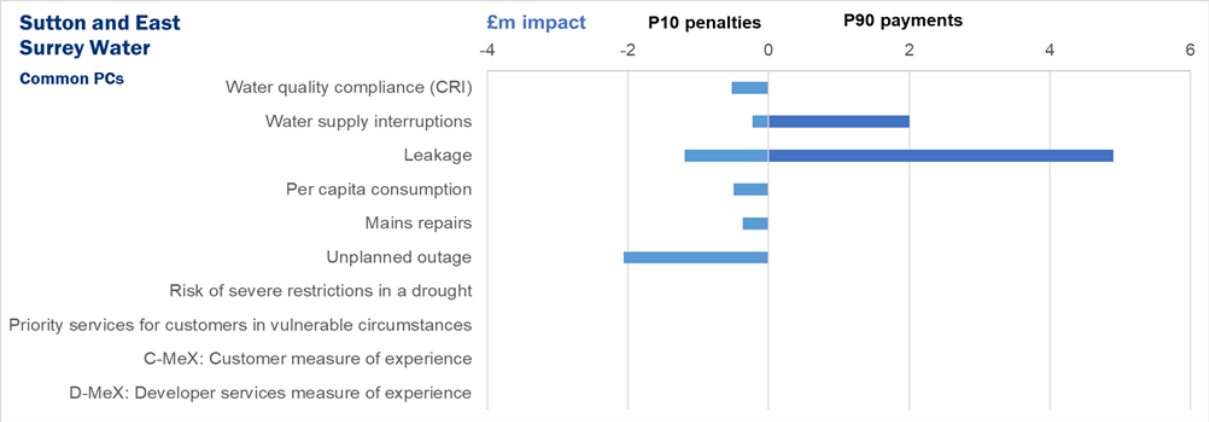


Table 2.4 provides an indication of the financial value of the overall package at the upper and lower extreme levels of performance (expressed as a percentage point impacts on RoRE (return on regulatory equity)) and the overall impact of our final determination decisions. Further information on how we have calculated these values is set out in the 'Delivering outcomes for customers policy appendix'.

Table 2.4: Impact of draft determination and final determination decisions on RoRE range

	Draft determination		Final determination	
	% of 5 year regulatory equity		% of 5 year regulatory equity	
	P10	P90	P10	P90
SES Water	-2.70	+0.52	-1.01	+1.28

The figures in the above tables are estimates. 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. Where, through these reasons, the vast majority of companies have caps and collars on a common performance commitment, we will apply caps and collars to all companies.

We are applying a standard sharing mechanism for all companies, 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 set out further detail of the mechanism in the 'Delivering outcomes for customers policy appendix'.

In our PR19 methodology, we decided to replace the existing service incentive mechanism (SIM) with two new common performance commitments to incentivise companies to provide an excellent 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 operate from April 2020 and incentivise companies to improve their performance relative to other water companies and the wider economy.

We set out further details on how C-MeX and D-MeX will operate in the 2020-25 period, including any changes from draft determinations, in the 'Customer measure of experience (C-Mex) and developer services measure of experience (D-Mex) policy appendix'.

2.3 Delivering a framework for resilience in the round

Resilience is one of our four themes for PR19. We set out our expectations for water companies' business plans in our final methodology. SES Water's September 2018 business plan falls short of demonstrating that the company has applied an integrated resilience framework that will deliver resilience in the round. It does however present a package of stretching asset health and bespoke performance commitments. It also considers assessment of risks to financial resilience, along with an approach to reduce gearing.

We recognise that it may take some time for companies to fully understand best practice approaches to resilience in the round and implementing a systems-based approach to resilience. In our initial assessment of business plans, we set SES Water an action (SES.LR.A2) to develop a resilience action plan which demonstrates that it has a framework in place to deliver resilience in the round, and to submit this to us by 22 August 2019. We expected the resilience action plan to build upon the feedback that we provided following our initial assessment of the business plan.

SES Water's resilience action falls significantly short of our expectations in many areas. In particular, we are concerned that:

- the company does not demonstrate how the maturity assessment is used to identify specific priority actions for resilience improvements. We expect the company to clearly demonstrate how its action plan is influenced by an understanding of its baseline maturity;
- the company provides insufficient evidence that some of the concerns we raised in the initial assessment of business plans have been adequately addressed. We expect the company to clearly respond to our feedback and demonstrate how this informed the development of its action plan; and
- the company's action plan lacks sufficient detail to give us confidence that a robust plan is in place for the company to deliver an integrated resilience framework. We expect the resilience action plan to provide sufficient detail to demonstrate a robust path to implementing the company's action plan, including clear governance and accountable owners for actions.

Overall, SES Water, along with the sector, has further work to do to implement a fully integrated resilience framework. The company should continue to work with the sector, with Ofwat, and across sectors to incorporate best practice and address the concerns highlighted about its resilience framework above. Ofwat plans to engage the sector through its strategy to encourage further joint development of resilience approaches to accelerate best practice through the industry. We also may consider the progress companies have made as part of assessing company business plans in the 2024 price review.

3 Cost allowances

Key changes from the draft determination

- Our final determination allowance for SES Water is £254.6 million for the wholesale services. This compares with £224.8 million at draft determination. In retail, our final determination allowance is £27.8 million, compared with £26.7 million at draft determination.
- Our base allowance is affected by a number of changes we have made since draft determinations:
  - we include company outturn data from 2018-19 in our econometric models;
  - we exclude non-section 185 diversions costs (i.e., diversions other than those required by section 185 of the Water Industry Act 1991) from our econometric models and allow companies to recover related income outside the price control, from the relevant transport authority;
  - we strengthen the catch-up challenge applied to wholesale modelled base costs. We use the 4th placed company as an efficiency benchmark, rather than the 5th place (upper quartile) company at draft determinations;
  - we reduce the frontier shift challenge from 1.5% per year to 1.1% per year, but we extend to all wholesale base costs.
- Following representations from SES Water we make allowances for enhancement resilience (£6.4 million) and electricity costs (£10.5 million) after considering additional evidence provided.
- We revise our leakage assessment approach and make an allowance of £8.6 million.
- We make a £1.7 million upward adjustment to our base allowance for water network plus. The adjustment is due to a relatively high forecast of population growth in 2020-25 in the company's supply area.
- For final determinations we apply a frontier shift challenge of 1.1% per year to metering enhancement costs.

Throughout price review 2019 we set out that we expect companies to demonstrate an increase in cost efficiency. In our final determinations, we set a cost-outcomes package that provides a strong incentive for companies to invest and operate efficiently and at the same time deliver a marked improvement in their level of performance, particularly on outcomes that matter to customers and the environment. Our cost-outcomes package is demanding but achievable. It will incentivise companies to innovate, which will pave the way for a more efficient, higher performing sector, with more meaningful, trusted relationship with customers.

SES Water submits a business plan with forecast base costs that are higher than its historical costs. To ensure customers pay only for efficient costs, we challenge the company's proposed costs and investment programme where appropriate. At draft determinations, the company had a large cost gap of 18%. For the final determination, the gap has reduced to 7%, partly as a result of the company's £8.7 million reduction in overall costs, and also due to allowances we make following representations for leakage, resilience, electricity usage and population growth.

Our main challenge on the company's proposed costs is with its retail costs. SES Water has the least efficient forward-looking residential retail costs in the industry, and while we address the company's concerns with the retail model, it has not resulted in a significant increase in our allowance.

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 'SES Water – Cost efficiency final determination appendix' we provide more detailed information on our cost challenge for enhancement expenditure, our allowance for cost adjustment claims and transitional expenditure and our unit cost adjustments related to uncertain schemes in WINEP.

3.1 Allowed expenditure for wholesale services

Table 3.1 shows total expenditure (totex) allowances by year and by wholesale price control for the period 2020-25. We phase our allowed totex over 2020-25 using the company business plan totex profile.

Table 3.1: Totex[1] 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 August 2019 - total
Water Resources	5.2	5.3	5.0	4.7	4.7	24.8	23.7
Water network plus	47.7	51.3	47.4	42.2	41.2	229.8	243.6
Total	**52.9**	**56.5**	**52.4**	**46.9**	**45.9**	**254.6**	**267.3**

[1] Totex includes all costs. This includes pension deficit recovery costs, 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 components of our totex allowance. The main components are base and enhancement costs. Base expenditure refers to routine, year on year costs, which companies incur in the normal running of their business to operate, maintain and incrementally improve service to customers. Enhancement expenditure refers to investment for the purpose of enhancing the capacity or quality of service beyond base level.

Our base costs for wholesale water include operating and maintenance costs, as well as costs associated with the connection of new developments (i.e., new developments and new connection costs) and costs for addressing low pressure.

We adjust allowed costs to reflect a change in the accounting treatment of leases as discussed in the 'Securing cost efficiency technical appendix'. The company proposed no adjustment in its business plan.

Our draft determination allowance included all revenues and costs in relation to diversions. This approach was criticised by companies who said that it did not take into account forecast step changes in diversions costs for some companies as a result of large infrastructure projects such as High Speed 2 (HS2). Following our draft determinations consultation, we exclude revenue relating to diversions other than those required by section 185 of the Water Industry Act 1991 ('non-section 185 diversions').

Non-section 185 diversions costs are included in table 3.2. Companies will be able to recover most of the non-section 185 diversions costs directly, usually from transport authorities, outside of the price control. This is in addition to our total revenue allowance.

Table 3.2: Totex[1] by wholesale price control and type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Water resources	Water network plus	Total
Base expenditure	23.9	179.9	203.8
Enhancement expenditure	0.9	38.9	39.8
Operating lease adjustment	-	-	-
Gross allowed totex for calculation of cost sharing rates	**24.8**	**218.8**	**243.6**
Strategic regional water resources solutions and other cash items	-	-	-
Third party costs	-	9.8	9.8
Non-section 185 diversions	-	1.2	1.2
Ex-ante cost sharing adjustment	-	-	-
Gross totex	**24.8**	**229.8**	**254.6**
Grants and contributions after adjustment for income offset[1]	-	20.1	20.1
Net allowed totex used in PAYG calculation	**24.8**	**209.8**	**234.6**
Pensions deficit recovery costs[2]	-	-	-
Total	**24.8**	**209.8**	**234.6**

[1] Includes price control and non-price control grants and contributions.
[2] We are displaying pension deficit recovery costs separately as they are not included in the calculation for PAYG (see section 4).

Movement in allowed wholesale expenditure between draft and final determinations

Table 3.3 compares our totex allowance at final determination to our allowance at draft determination. The table only includes base and enhancement expenditure. That is, it excludes pension deficit recovery costs, third party costs, and costs for strategic regional water resources development where relevant.

Following the change in approach to non-section 185 diversions costs discussed above, for final determinations, our allowance also excludes non-section 185 diversions costs of the amount stated against these cost in table 3.2. Our draft determinations allowance does not exclude these costs.

Table 3.3 also provides the company's requested costs in its April 2019 submission, and its revised requested costs in August 2019, in response to our draft determinations for slow-track companies. Table 3.4 provides further detail.

Table 3.3: Totex by service, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price Control	Company April 2019	Company August 2019	Draft determination allowance	Final determination allowance
Wholesale water	258.3	256.0	214.9	243.6

Table 3.4: Totex by type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Draft determination allowance	Final determination allowance
Base expenditure	189.5	203.8
Enhancement	25.3	39.8
- Environmental obligations (WINEP)	1.0	1.0
- Supply-demand balance and metering enhancement	22.2	30.3
- Resilience enhancement	0.0	6.4
- Other enhancement (including lead standards and catchment management)	2.1	2.1

3.2 Wholesale base expenditure

Table 3.5 shows a comparison between the company's requested and our allowed base expenditure.

Table 3.5: Base expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price control	Company August 2019[1]	Final determination allowance
Water Resources	22.8	23.9
Water Network plus	180.1	179.9
Total	**202.8**	**203.8**

[1] Company business plan base costs exclude enhancement opex.

For final determinations, we retain our approach of including growth related expenditure in our base econometric models. We have also made an adjustment depending on whether the company operates in an area with a relatively high or low

forecast of population growth, relative to the historical average for the sector. This follows representations made at draft determinations that the models did not adequately compensate for companies with a high growth forecast. We also consider that the models overcompensate for companies that operate in an area with a low growth forecast. We consider that using the symmetrical adjustment approach set out in our PR19 methodology best accommodates for these factors.

As the population growth forecast in SES Water's area for the period 2020-25 is higher than the historical average growth rate in the sector, we make a positive adjustment to the company's wholesale water base allowance of approximately £1.7 million. More details of our approach can be found in the 'Securing cost efficiency technical appendix'.

SES Water submits a cost adjustment claim of £10.5m related to electricity usage. The company argues that because it abstracts more than 85% of its supplied water from groundwater sources in greensand and chalk aquifers located deep below ground, it needs to use more energy to per unit volume of water to pump the water to supply. While our econometric models have a variable to capture energy use (the number of booster pumping stations), the company claims that in its case, it does not capture its high energy requirements. The company highlights that its average pumping head is amongst the highest in the sector, it has the lowest number of booster pumping stations per lengths of main, which is the variable we use in our treated water distribution and wholesale water econometric models to account for energy use. We rejected this claim at draft determination. The company submits sufficient and convincing evidence in its August 2019 representations to draft determinations and we allow the claim in full, split £6.9 million[6] water network plus and £3.5 million water resources.

SES Water has a statutory obligation to partially soften water. The company is unique in this regard among English and Welsh companies. The company submits a cost claim of £11.5 million for the additional costs to maintain and operate the treatment processes associated with softening. We accept the unique requirement and make an adjustment to our base allowance of £11.5 million in respect of this claim. As discussed in chapter 2, we introduced a performance commitment to ensure that customers were protected if the company fails to deliver its obligations.

[6] Amendment made to figure, updated from £3.9 million to £6.9 million for water network plus

3.3 Enhancement expenditure

For wholesale enhancement expenditure we challenge the scope of work, the evidence provided to support solution options, and the efficient delivery of programmes. We cost benchmark with the rest of the industry where we can.

Table 3.6 summarises our allowances for enhancement expenditure.

Table 3.6: Enhancement expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price control	Company August 2019	Final determination allowance
Water Resources	0.9	0.9
Water Network plus	52.2	38.9
Total	**53.1**	**39.8**

Our final determination allows SES Water £39.8 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £19.1 million for new meter installations
- £11.2 million for supply-demand balance improvements
- £6.4 million for improving resilience

Below we discuss key areas of our determination on enhancement cost proposals. Our document 'SES Water - Cost efficiency final determination appendix' sets out in more detail the cost allowances by investment area for each price control, and we give full reasoning in our published cost assessment models (enhancement feeder models and cost claims feeder models).

Resilience

In our draft determination for SES Water we did not make an allowance for water resilience enhancements. SES Water provides additional evidence in its representations for the resilience programme. After considering this evidence, we make a final determination allowance of £6.4 million to complete a second source of supply for customers in SES Water's area. This is part of a multi-AMP resilience programme supported by past investments to interconnect the company's water treatment works. We consider that the allowed investment will protect 67,000 customers against supply interruptions triggered by asset failures in areas currently without an alternative supply. However, we do not make an enhancement allowance to provide by-passes around service reservoirs where none currently exist as this is unrelated to the resilience risks the company presents and is closely linked to

maintaining these assets. In addition, we apply further cost challenges on the basis of insufficient evidence that the company considers a range of options and that its costs are efficient.

Leakage

We expect an efficient company to achieve its stretching performance commitments from our base allowance. Only where the company's performance commitment goes beyond the industry forecast upper quartile leakage performance, do we make an enhancement allowance for leakage reduction. As this is achieved by SES Water, we allow funding under enhancement, for the proportion of the leakage reduction it will deliver that is beyond the forecast upper quartile threshold, approximately 55% of its proposed total leakage reduction. In 'Securing cost efficiency technical appendix' we set out our policy on the funding of leakage reduction costs, including how we derive the upper quartile threshold for leakage enhancement costs.

We challenge the costs the company associates with this reduction, noting that the company's unit rate for leakage reduction is the highest in the industry. We assess its unit cost based on the evidence it provides within its 'Mains replacement' cost adjustment claim. We recognise that the company provides some evidence to support its claim but consider it is insufficient to clearly demonstrate the costs it proposes are efficient and that the benefits it expects are fully justified. We also consider that the company does not clearly demonstrate why the split of mains replacement and active leakage control selected represents the best value approach to reducing leakage. We therefore apply a 10% efficiency factor to the leakage reduction expenditure that SES Water requests. The company requests £17.4 million for leakage reduction, which includes a mains replacement component of £13.1 million, and we make an allowance of £8.6 million at final determination accounting for the proportion of leakage reduction beyond the threshold and our efficiency challenge. This is an increase from draft determination where we made no allowance.

Metering

SES Water's representation request for £21.1 million to install new meters is unchanged from its April 2019 plan. We make an allowance for metering based on our unit cost model. At final determination we apply a frontier shift to the model output which results in a reduction in our allowance. However, we also make an adjustment based on a joint assessment of the metering and supply demand balance allowances which increases the company's metering allowance reducing the impact of the frontier shift. Therefore, following all the adjustments, at final determination we

make an allowance of £19.1 million, which is a decrease of £0.4 million from our draft determination allowance.

3.4 Cost sharing

In the water resources and water network plus controls we have a cost sharing arrangement. In these controls, 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 calculated 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 calculate the company's view of costs based on a 50% weight on the company's final cost proposals in its August 2019 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 3.7 sets out the cost sharing rates for PR19 and net totex that is subject to cost sharing at the end of the 2020-25 period. We calculate cost sharing rates based on totex gross of grants and contributions (but after making adjustments for operating leases and excluding costs of strategic regional water resources development costs, third party costs and pension deficit recovery costs). At the end of the 2020-25 period, we will apply cost sharing to totex net of grants and contributions.

Table 3.7: Cost sharing rates for 2020-25 and totex for end-of-period reconciliation

	Water resources	Network plus - water
Totex for cost sharing rates – September 2018 business plan	23.2	234.2
Totex for cost sharing rates – August 2019	23.7	232.3
Weighted company view of totex for cost sharing rates	23.5	233.2
Gross allowed totex for cost sharing rates	24.8	218.8
Cost sharing ratio	1.05	
Cost sharing rate – outperformance	45%	
Cost sharing rate – underperformance	55%	
Grants and contributions before the deduction of income offset (£m)	-	20.5[7]
Abstraction charges and business rates	5.2	14.1
Net allowed totex subject to cost sharing reconciliation	19.7	184.2[8]

3.5 Allowed expenditure in residential retail

Based on our benchmarking analysis, SES Water is among the least efficient companies in residential retail both on a historical and a forward-looking basis. Our allowance for the company is 21% lower than what it requests. Our challenge is therefore significant, likely reflecting a lack of self-challenge from the company on its business plan proposals in residential retail relative to other companies and relative to its historical expenditure. We also note that the company is among those most significantly underperforming on its residential retail allowances for 2015-20 despite our allowing a glide path as part of PR14 final determinations. We maintain our view that our residential retail model provides an appropriate basis for setting cost allowances for SES Water.

[7] Amendment made to Grants and contributions before the deduction of income offset (£m) Network plus – Water
[8] Amendment made to Net allowed totex subject to cost sharing reconciliation Network plus – Water

Table 3.8 sets out our total expenditure allowance for residential retail. Our allowance does not include any of our allowed pension deficit recovery costs. We allocate all these costs to wholesale controls.

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

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	5.2	5.4	5.6	5.7	5.9	27.8
Company view	7.9	6.8	6.9	6.9	6.9	35.3

Note that 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.

3.6 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 are to consider direct procurement for customers for discrete, large-scale enhancement projects expected to cost over £100 million, based on whole-life totex.

SES Water's business plan did not identify any schemes that are suitable for direct procurement for customers. We expect any other major schemes which may arise due to significant changes to SES Water's business plan to be reviewed against the direct procurement for customers criteria, as detailed in the PR19 methodology. If the criteria are met, we expect SES Water to undertake further work to review detailed costs and commitments to ensure delivery is via the most efficient route, and to assess delivery via direct procurement for customers, to ensure that customers receive the best value.

4 Calculation of allowed revenue

Key changes from the draft determination

The key changes we are making to the calculation of allowed revenue in the draft determination are:

- We allow £301.5 million of revenue across all price controls for SES Water in the final determination, compared to £274.5 million in the draft determination and £313.1 million in the company's April 2019 revised business plan.
- The allowed return on capital for the wholesale price controls is 2.92% (on a CPIH basis, 1.92% on a RPI basis), a reduction of 0.16 percentage points from our draft determination, based on our assessment of market evidence. The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.
- Taking account of company representations, we revise our approach to determine the mix of operating and capital expenditure to take better account of the nature of our decisions on cost allowances. We apply the updated approach in our technical intervention to PAYG rates.
- We increase PAYG rates to bring forward allowed revenue by £2 million to address a notional financeability constraint. This compares to £1 million in the draft determination
- Allowed revenue includes SES Water's contribution to the innovation competition.
- We revise our approach to calculating grants and contributions.
- We reflect SES Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission.

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.

4.1.1 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 allowed return on 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 includes income from connection charges, infrastructure charges and s185 diversion recharges. The total grants and contributions amount deducted from totex may not agree to this amount, as we only include grants and contributions income relating to the price control (and some income is outside the price control).
- 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. In a change from our draft determination, we also now include diversions recharges which are in respect of the New Roads and Street Works act 1991 activities and other non-section 185 diversions. 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.
- Innovation competition – this represents the additional revenue that the company will collect from its customers for the purpose of a collectively funded innovation

competition for the period 2020-25. The amount each company's customers will contribute will be proportionate to individual company revenue at Draft Determinations. We expect the revenue collected from customers to be ring-fenced and administered so that it will not be used for purposes other than the innovation competition.

- 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 SES 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 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 – Final determination	Total - Draft determination
Pay as you go	20.2	102.7	123.0	109.3
RCV run-off	4.9	92.6	97.5	96.1
Allowed return on capital	1.6	31.7	33.4	35.0
Revenue adjustments for PR14 reconciliations	0.0	1.4	1.4	0.3
Fast track reward	0.0	0.0	0.0	0.0
Tax	0.3	5.6	5.9	5.5
Grants and contributions after adjustment for income offset (price control)	0.0	19.0	19.0	8.7
Deduct non-price control income	-0.2	-4.5	-4.8	-4.8
Innovation competition	0.0	1.0	1.0	0.0
Revenue re-profiling	0.0	-0.1	-0.1	0.1
Final allowed revenues	26.9	249.4	276.3	250.4

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'SES Water - Allowed revenue appendix' in tables 1.1 and 1.2.

In our new strategy for regulating water and wastewater companies in England and Wales, we highlight that innovation is crucial for meeting the challenges the sector faces.

The adoption of innovative approaches is key to delivering long-term resilience and great customer service at an affordable price, and the sector will need to step up and increase innovation in order meet the strategic challenges it faces in a cost-effective

and sustainable way. We also want to see companies work more effectively together and with their supply chain to better tackle these challenges.

Our outcomes and total expenditure approach facilitate this innovation, by giving companies the flexibility and freedom to adopt innovative means of delivering services. We are promoting innovation by setting SES Water stretching outcome performance commitments. Our outcome delivery incentives approach means that companies have to return money to customers where they fall short, but it also gives companies the opportunity to earn additional financial payments if they successfully improve performance and deliver for customers above and beyond the level expected of most companies. This encourages companies to look for innovative ways of delivering better services to customers and improving the environment.

However, as well as our existing package of measures which encourages companies to innovate individually, we have been considering how we can stimulate innovation more widely in the sector and encourage collaborative innovation initiatives.

In our new strategy consultation[9], we explored options for customer-funded interventions designed to drive innovation to benefit customers in the longer-term. Having reviewed the responses to the consultation, we are publishing our decision in 'Driving Transformational Innovation in the Water Sector' alongside the PR19 final determinations, confirming that we are making up to £200 million available for innovation activities for the period 2020-25 through the introduction of an innovation competition. We will work together with companies and other stakeholders in the sector to set up a competition which will effectively drive innovation in the sector to the benefit of customers across England and Wales.

4.1.2 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.

[9] Ofwat's emerging strategy: Driving transformational innovation in the sector.

- Our methodology set out an early view of the retail margin that applies for the retail price controls. This was used by SES Water in its business plan and is unchanged in our final determinations.

Allowed revenue for the residential retail control is set on a nominal basis. We present the make-up of the allowed revenue in nominal prices in table 4.2.

Table 4.2: Retail margins, 2020-25 (nominal price base)

	Draft determination	Final determination
Total wholesale revenue - nominal (£m)	266.2	284.6
Proportion of wholesale revenue allocated to residential (%)	83.6%	83.6%
Residential retail costs (£m)	26.7	27.8
Total retail costs (£m)	249.3	265.8
Residential retail net margin (%)	1.0%	1.0%
Residential retail net margin (£m)	2.5	2.7
Residential retail adjustments (£m)[1]	-2.7	-2.5
Residential retail revenue (£m)[2]	26.5	27.9

[1] Residential retail adjustments for the PR14 residential retail service incentive mechanism and residential retail revenue reconciliations are set out in table 4.11. The figures in table 4.2 are in nominal prices, and the figures in 4.11 are in 2017-18 FYA CPIH deflated prices. The difference between the two tables is due to the difference in price bases.
[2] Residential retail revenue is the sum of the net margin, retail costs, and adjustments. Company view may not sum as this may include other adjustments.

We set out the calculation of residential retail revenue on an annual basis in the 'SES 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. For the final determinations we revise our approach to the calculation of PAYG rates to better reflect the source of changes we make to costs claimed by companies as a result of our totex cost assessment. Our revised approach follows a process of further consultation with companies following the submission of representations on the draft determination. We explain our revised approach in 'Securing cost efficiency technical appendix.

In this section we set out our approach to calculating the PAYG rates, the RCV to which the allowed return on capital is applied and the RCV run-off rates.

4.2.1 PAYG in allowed revenue

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 4.5 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 'SES Water - Allowed revenue appendix', tables 2.1 and 2.2.

To PAYG totex we add the allowed costs for pension deficit recovery set out in table 3.2 to derive the 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
Totex allowance (£m)	24.8	209.8	234.6
Final determination PAYG rate (%)	81.5%	49.0%	52.4%
Pay as you go totex (£m)	20.2	102.7	123.0
Pension deficit recovery cost (£m)	-	-	-
Total pay as you go (£m)	**20.2**	**102.7**	**123.0**

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

	Water resources	Water network plus
Original company plan (%)	80.8%	46.7%
Draft determination (%)	81.5%	46.9%
Final determination (%)	81.5%	49.0%

In the draft determination, we applied SES Water's approach to PAYG rates to recover in each year an amount equivalent to operating costs. We 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 compared with the business plan. We applied an uplift of 0.5% for all wholesale controls proposed in the company's April 2019 business plan to improve notional financeability. The uplift brought forward £1 million of revenue in the draft determination.

In its representations, SES Water states that it accepts the technical intervention in principle but proposes a further update to recover operating expenditure in its representation case based on further changes it proposes to allowed costs.

Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions.

In order to calculate the mix of operating and capital expenditure we follow the approach set out in 'Securing cost efficiency technical appendix'. We set out how we apply the technical intervention in the 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our determinations.

We are increasing the uplift to PAYG rates for all years for all wholesale controls to 0.80% to increase cash flows in the 2020-25 period and to improve financial ratios targeted by the company on a notional basis, bringing forward £2 million of allowed revenue from future periods. We set out our financeability assessment in section 5.2.

The movements in PAYG rates between the company plan, the draft determination and final determination reflect the differences in the mix of operating and capital expenditure in our totex allowance along with the increase to PAYG rates for notional financeability in the final determination.

4.2.2 Opening RCV adjustments

As part of the business plan SES Water proposed allocations of the RCV for the water resources price control based on Ofwat guidance. We are allocating the company's RCV from the existing wholesale control to the water resources control in accordance with the proportions proposed by SES 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 follow the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. The company proposes no adjustment in its business plan.

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

	Water resources	Water network plus
RCV – 31 March 2020	258.9	
% of RCV allocated by control	5.23%	94.77%
RCV – 31 March 2020	13.5	245.3
Midnight adjustments to RCV	-0.4	-7.3
Midnight adjustments relating to operating leases	-	-
Opening RCV – 1 April 2020	13.1	238.1

4.2.3 Allowed return on capital

Companies are allowed a return on the RCV, equal to the allowed return on capital.

SES Water's business plan incorporates the draft determination allowed return on capital plus a company-specific adjustment of 25 basis points on the overall cost of debt which equates to a figure for the wholesale price controls of 3.23% - CPIH deflated (2.22% - RPI deflated).

We have not accepted the company's proposal for a company-specific adjustment. We set out the detail of our assessment supporting this decision in our 'Allowed return on capital technical appendix – A1'.

The allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated). We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.

The PR19 methodology confirmed we are transitioning to CPIH as our primary inflation index 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 4.6 and table 4.7 set out the opening and closing balance for each component of RCV as of 1 April 2020 and 1 April 2025 respectively.

The PR19 methodology confirms our protection of the value of the RCV as at 31 March 2020 across each of the wholesale price controls. This applies to the RCV

that is defined as 'RPI inflated RCV' and 'CPIH inflated RCV' in tables 4.6 and 4.7; this RCV is run-off (or amortised) over time. Totex that is added to the RCV from 1 April 2020 is stated as 'post 2020 investment'.

In determining the 'allowed return on capital' revenue building block, we apply the relevant deflated allowed return on capital to the average RCV for the year for each component (RPI inflated, CPIH inflated and post 2020 investment). This results in an allowed return on capital for each wholesale control over the period 2020-25 as set out in table 4.8.

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

	Water resources	Water network plus	Total
RPI inflated RCV	6.6	119.0	125.6
CPIH inflated RCV	6.6	119.0	125.6
Other adjustments	-	-	-
Total RCV	**13.1**	**238.1**	**251.2**

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

	Water resources	Water network plus	Total
RPI inflated RCV	4.8	86.9	91.7
CPIH inflated RCV	4.5	82.1	86.6
Post 2020 investment	3.8	88.2	92.0
Other adjustments	-	-	-
Total RCV	**13.1**	**257.2**	**270.3**

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

	Water resources	Water network plus	Total
RPI inflated RCV	0.5	9.8	10.4
CPIH inflated RCV	0.8	14.5	15.3
Post 2020 investment	0.3	7.4	7.7
Other adjustments	-	-	-
Allowed return on capital	**1.6**	**31.7**	**33.4**
Company April 2019 – return on capital	2.0	39.7	41.7

Note that allowed 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 allowed return on capital for each year of the price control for each wholesale control is shown in the 'SES Water - Allowed revenue appendix' in tables 4.1 and 4.2.

4.2.4 RCV run-off

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

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

	Water resources	Water network plus	Total
CPIH inflated RCV	2.0	36.9	39.0
RPI inflated RCV	2.0	36.8	38.9
Post 2020 investment	0.8	18.8	19.6
Total RCV run-off	**4.9**	**92.6**	**97.5**

Note that 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).

For the draft determination, we applied SES Water's RCV run-off rates which are based on recovering an amount equivalent to capital maintenance changes. SES Water does not make any representations in relation to RCV run-off rates and we continue to apply the company's RCV run-off rates for the final determination.

Table 4.10 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 and final determinations.

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

	Water resources	Water network plus
Company April 2019 (%)	7.07%	7.08%
Draft determination (%)	7.07%	7.08%
Final determination (%)	7.07%	7.08%

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

The annual rates for each wholesale control are set out in the 'SES Water - Allowed revenue appendix' in table 5.1 and 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, and the inflation correction to the RCV from the capital expenditure incentive scheme (CIS). 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. 'SES Water - Accounting for past delivery final decisions' provides a detailed explanation of all policy interventions we are making in the models. Table 4.11 summarises our interventions. Table 4.12 sets out the resulting adjustments to revenue and the RCV. The 'SES Water - Accounting for past delivery appendix' sets out how these adjustments are allocated across controls and how the RCV adjustment feeds into the midnight adjustments to RCV set out in table 4.5.

The 'Accounting for past delivery technical appendix' sets our further details on our reconciliation of PR14 incentives, the residential and business retail service incentive mechanisms and our deliverability assessment.

For outcome delivery incentives, the information we use 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 plan 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 are designating 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 do not expect a significant impact on bills. If, contrary to expectations the bill impact is more significant, we 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 use forecast information for 2019-20 to reconcile these outcome delivery incentives. For the avoidance of doubt, no application is required in 2019 for in period determinations.

Table 4.11: Reconciliation of PR14 incentives, interventions (2017-18 prices, unless otherwise stated)

Incentive	Intervention(s)
Outcome delivery incentives	We are intervening to correct an error relating to the 2015-16 outperformance payment for performance commitment A3 (supply interruptions >3 hours). We are including an adjustment in 2015-16 of £0.200 – £0.191 = £0.009 million (2012-13 prices). Our minor intervention increases the water revenue adjustment at the end of the 2015-20 period from £0.974 million to £0.984 million.
Residential retail revenue	We are intervening to round the company's modification factor figures to 2 decimal places to ensure consistency with the 'PR14 reconciliation rulebook'. We are also including a figure of 3.74% for the 'Materiality threshold for financing adjustment - Discount Rate' in line with the 'PR14 reconciliation rulebook'. Overall, our minor interventions do not change the total residential retail revenue payment at the end of the 2015-20 period which remains at £0.120 million.
Wholesale revenue forecasting incentive mechanism	No interventions required.
Totex	We are intervening to change the 'Water: Final menu choice' figure to full decimal accuracy as calculated in the PR14 populated final determination models. Our minor intervention does not change either the water RCV or water revenue adjustments at the end of the period which remain at - £0.380 million and - £0.578 million respectively.
Land sales	No interventions required.
Residential retail service incentive mechanism	We are intervening to set SES Water's residential retail service incentive mechanism adjustment to -7.30% of residential retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to -£2.262 million in total revenue over the period. This reduces revenue relative to the company's estimate of the mechanism's impact and is driven by updating our analysis to take account of companies' finalised scores for 2018-19.
PR09 blind year adjustments	No interventions required.

Table 4.12: Reconciliation of PR14 incentives, 2020-25 (£ million, 2017-18)

Incentive	RCV adjustments		Revenue adjustments	
	Company view[1]	Ofwat view[1]	Company view[1]	Ofwat view[1]
Outcome delivery incentives	0.0	0.0	1.0	1.0
Residential retail revenue	N/A	N/A	0.1	0.1
Wholesale revenue forecasting incentive mechanism	N/A	N/A	0.6	0.6
Totex	-0.4	-0.4	-0.6	-0.6
Land sales	-0.9	-0.9	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	-0.9	-2.3
PR09 blind year adjustments[2]	-6.3	-6.3	0.3	0.3
Water trading	N/A	N/A	0.0	0.0
Other adjustments	0.0	0.0	0.0	0.0
Total	**-7.7**	**-7.7**	**0.5**	**-0.8**
Total post profiling[3]	**N/A**	**N/A**	**0.6**	**-0.9**

[1] The company view is based on data from the 15 July 2019 company submissions. It does not reflect impacts of the subsequent representations. The Ofwat view is based on the 15 July 2019 company submissions and takes account of representations and any interventions we are making.
[2] PR09 blind year adjustments includes the CIS RCV inflation correction. We show these separately in 'SES Water - Accounting for past delivery appendix'.
[3] 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.

4.4 Other allowed revenue

Other components of allowed revenue are:

- The fast track reward, where applicable;
- 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 final 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.
- 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 4.13: Calculation of other allowed revenue (£ million)

	Water resources	Water network plus	Total
Fast track reward	-	-	-
Tax	0.3	5.6	5.9
Grants and contributions (price control)	0.0	19.0	19.0
Deduct non-price control income	-0.2	-4.5	-4.8

4.4.1 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 and enacted UK corporation tax rates and associated reliefs and allowances as at 30 September 2019. Any future changes to tax rates and allowances will be taken account of in the tax reconciliation model, further details are set out in the 'Aligning risk and return: technical appendix'.

SES Water provided information in data tables relevant to the calculation of the expected tax charge. As we apply the same tax information to our final determination as used for the draft determination, any movement in the resulting tax allowance is driven by differences in taxable profits, which are as a result of our interventions in other areas.

Our draft determination required the company to provide further evidence to explain the scope of the third party review that was undertaken on its tax forecasts and the outcome of the work. SES Water provided a report from its auditors which provided commentary on the process taken by the company to prepare the tax forecast and

the reasonableness of the assumptions driving the forecasts. It also provided further detail on the work done by their external tax advisors. We have reviewed the additional evidence on assurance provided by SES Water and we consider this represents sufficient evidence of its assurance.

Table 4.14: Tax (£ million) – Breakdown by price control

	Water resources	Water network plus	Total
Tax	0.3	5.6	5.9

4.4.2 Grants and contributions

Companies receive grants and contributions from developers towards company expenditure to:

- reinforce the network as a consequence of new properties being connected;
- connect a new property (e.g. the meter and connection pipe);
- provide new water mains or public sewers (i.e., requisitions); and
- move an existing main or sewer or other apparatus at the request of a third-party (i.e., diversions).

Grants and contributions

Grants and contributions before the deduction of income offset allowances (i.e., 'gross' grants and contributions) are used to calculate net totex for cost sharing and within the developer services reconciliation adjustment, as explained in 'Our approach to regulating developer services'.

Grants and contributions after the deduction of income offset allowances (i.e., 'net' grants and contributions) are used to calculate net totex for use in the financial modelling. This ensures that income offset allowances, that are funded by existing customers rather than developers, are captured within net totex that is used to calculate pay-as-you-go revenue and RCV additions. Developer services costs that are funded by developers are excluded from net totex, and are instead treated as grants and contributions within the financial model (as shown in tables 3.2 and 4.1).

Our approach to calculating 'gross' and 'net' grants and contributions is outlined in 'Cost efficiency technical appendix'. The main difference from draft determinations is that we no longer estimate a cost recovery rate for each company. The starting point for each calculation is 'gross' grants and contributions reported in companies'

business plans. To arrive at 'net' grants and contributions we deduct company-specific income offset allowances rather than assume a common recovery rate for all companies. We also apply the modelled base cost efficiency challenge to grants and contributions to ensure alignment between grants and contributions and cost assessment.

Table 4.15 below shows our assumed amounts of 'gross' grants and contributions (price control) that is used to calculate net totex for cost sharing.

Table 4.15: Grants and contributions before the deduction of income offset allowances (£ million)

	Water resources	Water network plus	Total
Grants & contributions (price control; before deduction of income offset allowances)	0.0	20.5	20.5

Table 4.16 below shows our assumed amounts of 'net' grants and contributions (price control) that is captured within net totex that is used to calculate pay-as-you-go revenue and RCV additions.

Table 4.16: Grants and contributions after the deduction of income offset allowances (price control) (£ million) – breakdown by price control and category

	Water resources	Water network plus	Total
Grants & contributions (price control)	0.0	19.0	19.0

Grants and contributions (non-price control)

For final determinations, we set non-section 185 diversions income outside of the price control, as explained in 'Our approach to regulating developer services'.

Table 4.17 below shows our assumed amounts of grants and contributions (non-price control) that are made up of non-section 185 diversions income.

Table 4.17: Grants and contributions (non-price control) (£ million) – breakdown by price control and category

	Water resources	Water network plus	Total
Grants & contributions (non-price control)	0.0	1.0	1.0

4.4.3 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. For the final determination we confirm that diversions which are not requested under section 185 of the Water Industry Act 1991, for example, works under the New Roads and Street Works Act 1991 or those associated with High Speed 2, are also excluded from the price control. These are capital contributions and so do not get shown in tables 4.1 and 4.18.

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 final determination.

Table 4.18: Non-price control income (£ million) – Breakdown by price control

	Water resources	Water network plus	Total
Non-price control income	-0.2	-4.5	-4.8

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

4.4.4 Uncertainty mechanisms

Given the existence of other risk mitigation measures, the PR19 methodology said that final determinations would only include bespoke uncertainty mechanisms where robust and compelling evidence was presented for that item. SES Water does not propose any uncertainty mechanisms.

We are including a PR24 reconciliation mechanism for business rates in our final determination for SES Water along with all other companies because:

- 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.
- 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.

We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for SES Water along with all other companies serving England[10] because:

- The Environment Agency expects to consult on changes to its basis for setting abstraction licence fees during 2020 meaning that there is material uncertainty about company cost levels in 2020-25.
- Companies can only exercise limited control over cost levels by engaging with the consultation process and providing accurate information when required for licence fee setting purposes.

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 levels we have set.

[10] The Environment Agency's responsibilities apply only to England.

5 Risk analysis and financeability

Key changes from the draft determination

The key changes made to the risk analysis and financeability elements of the draft determination are:

- For the final determination, we apply our view of a sector risk range for totex, C-Mex, D-Mex and financing costs (including embedded debt) as part of our assessment of risk ranges for our final determination. We also apply updated views on risk ranges for outcome delivery incentives, determined under our Outcomes Framework.
- We revise our notional dividend yield to 3.00% (from 3.15% in the draft determination) and apply a dividend growth of 1.18% in our notional financeability assessment for SES Water. This takes account of the allowed cost of equity in the final determination.
- We revise our approach to pension deficit recovery costs in our financial modelling of the notional company to match cash out flow for pensions deficit recovery costs to the allowed funding.
- For the final determination we advance allowed revenue by £2 million to ensure our determinations are financeable on the basis of the notional structure.

We consider the final determination is financeable on the basis of the notional capital structure.

SES Water is responsible for ensuring it delivers its obligations and commitments in the context of its choice of capital and financing structure. We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25.

In this section we discuss the possible range of returns for the notional financial structure. In section 5.1 we present the risk ranges of our final determinations for SES Water. We comment also on the financeability of the final determination and any adjustments that we have made to the bill profile in section 5.2. We comment on the financial resilience of the actual capital structure in section 5.3.

5.1 Risk analysis

The PR19 methodology set out that we expect companies to demonstrate a clear understanding of financial risk to the delivery of their business plans and to explain and demonstrate how they manage and mitigate that risk. It required 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 the company's assessment of P10/P90 confidence limit values[11].

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 it 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[12]. The proportion of RCV (and notional regulatory equity) that is linked to RPI or CPIH varies 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.

In addition, base RoRE includes the margin for the retail price control. While the retail margin is 1% on retail and wholesale costs for all companies, it varies between companies when measured against regulatory equity.

Table 5.1 and figure 5.1 sets out the annual average risk ranges for SES Water in our final determination. The risk ranges show the plausible range of company returns based on SES Water's RCV and cost data for 2020-25, the allowed equity return and a notional gearing level of 60%. The final determination ranges reflect our approaches to the assessment of risk ranges for outcome delivery incentives and our approach to apply a common approach to the assessment of risk ranges for totex and financing costs for the sector.

Our PR19 methodology aims to increase the strength of financial incentives to better align the incentives placed on companies with the interests of customers. Our determinations aim to be stretching to encourage companies to deliver further efficiencies and better levels of service to customers. The incentives we put in place incentivise companies to outperform the cost allowances and performance

[11] 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.

[12] 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.

commitments set in our determinations, our incentive mechanisms also aim to protect customer interests where companies underperform.

SES Water has significant scope to earn upside from outperformance as well as the risk of lower returns from underperformance. The company has a positive skew on both totex and outcome delivery incentives. Our view is that an efficient company should be able to achieve the base return on the notional structure. The onus is on companies to manage the risk and effect of any downside scenarios while maintaining financial resilience.

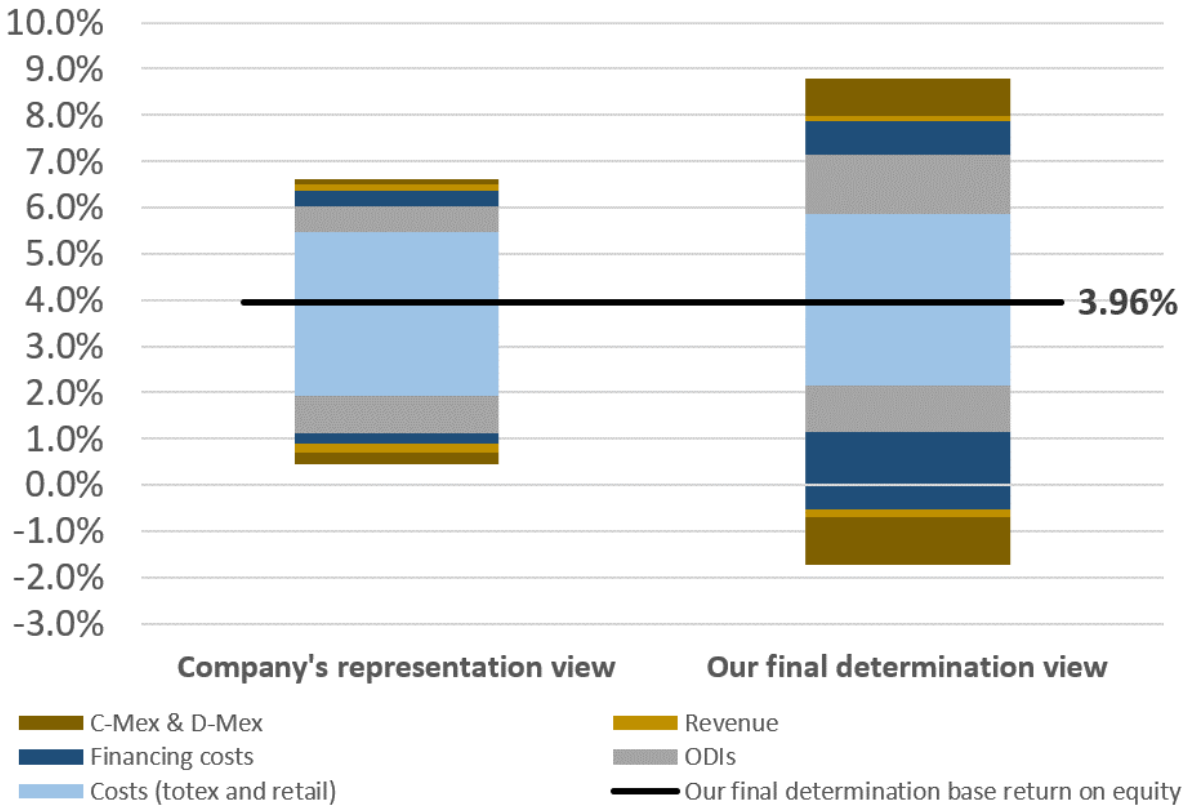
We state those risk ranges in table 5.1 against the cost allowances and base return on regulatory equity in our final determinations. These risk ranges are not fully comparable with our final determination ranges as they take account of company views of the cost efficiency and outcome delivery incentive stretch in our draft determinations which we revise for the final determinations.

Table 5.1: SES Water final determination risk ranges

	Range implied in company representation		Final determination ranges	
Base RoRE	-		3.96%	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-1.67%	1.16%	-1.44%	1.52%
Outcome delivery incentives	-0.80%	0.54%	-1.01%	1.28%
Financing costs	-0.24%	0.36%	-1.65%	0.74%
Retail costs	-0.36%	0.36%	-0.37%	0.37%
C-MeX and D-MeX	-0.24%	0.12%	-1.03%	0.80%
Revenues (includes Retail)	-0.19%	0.12%	-0.19%	0.12%
Total	**-3.51%**	**2.65%**	**-5.70%**	**4.83%**

We calculate the company's range based on the resubmitted ranges the company states in its representation that are in monetary terms. As we have calculated the ranges in the financial model used for the final determination we have not stated the company's view of the base equity return.

Figure 5.1: Company representation and final determination RoRE ranges for SES Water



Note that representation view is based on Ofwat's calculation of the RoRE ranges for the company using the final determination financial model and is based on the company submission that accompanied its representation. To facilitate comparison with our final determination, we present the risk range around the base allowed return on equity for SES Water's final determination.

The final determination risk range reflects the following interventions that we make for all companies:

- 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 outcome delivery incentive risk range has been determined under our Outcomes Framework as set out in table 2.4.
- 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.

We set out further details on the issues above in the ‘Aligning risk and return technical appendix’.

5.2 Financeability

Companies in the water sector must make significant investment both to maintain and deliver required enhancements to the asset base. Therefore it is important that companies are able to access finance on reasonable terms if they are to meet their obligations and commitments to customers. In recent price review periods, almost all of the new investment in this sector has been funded by debt and retained earnings, however, there may be a requirement for direct equity investment where there is a very significant investment requirement, to ensure companies maintain good credit quality.

We must set our determinations in the manner which we consider best calculated to satisfy our duties. Our financeability assessment considers whether the allowed revenues, relative to efficient costs, are sufficient for an efficient company to finance its investment on reasonable terms and to deliver its activities in the long term, while protecting the interests of existing and future customers. In carrying out our financeability assessment, we assume that an efficient company is able to deliver a level of performance that is consistent with our efficient cost allowances.

Our financeability assessment assumes there is no out/underperformance with respect to the levels of service provided to customers. Our approach protects the interests of customers as it ensures companies and their investors bear the consequences of inefficiency and underperformance in delivery of their obligations and commitments to customers.

We carry out our financeability assessment on the basis of the notional capital structure that underpins our allowed return on capital as companies are entitled to determine the financial structure appropriate for their circumstances, provided they bear the associated risks. For example, if a company’s choice of financing structure results in it incurring higher debt costs than reflected in our view of efficient allowed returns, the company will bear this cost. The approach is consistent with meeting all of our regulatory duties and with the approach we and other regulators have taken in previous reviews.

Our PR19 methodology requires companies to provide Board assurance that the business plan is financeable on both the notional and their actual capital structures and 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.

In its April 2019 business plan, SES Water set out that its Board assures that both the notional and actual capital structures remain financeable and that the plan protects customer interests in the short and long term. The company stated that its plan targeted a credit rating of Baa1 on a notional basis.

Subsequently, we asked companies to provide additional Board assurance, in their representation to our draft determination, that they will remain financeable, taking account of the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the allowed return. Companies also took account of these issues in the risk analysis presented in section 5.1.

In its representation to our draft determination, SES Water sets out that the Board provides assurance that the company is financeable. However, this is qualified based on acceptance of the company's representations. This assurance takes account of the allowed return on capital for the draft determination and the removal of the company-specific uplift to the cost of debt requested by SES Water, although the company continues to disagree with the disallowance of this uplift.

We have carefully considered the representations made by SES Water including the qualifications on the assurances provided. We have considered this in the context that the allowed return which is based on market data is lower than our draft determination and the basis on which the company provided assurance about the financeability of its plan. However we are satisfied that the market data supports our view that allowed returns are sufficient to reward investors for the risks they face in a sector that already benefits from significant risk protections[13]. We do not accept SES Water's request for a company-specific adjustment to the allowed return as set out in Section 4.2.3 and we set out the revisions we are making to our performance commitments and cost allowances elsewhere in this document. We consider the revenues allowed in our final determination, which reflect our assessment of efficient allowed costs, are sufficient for SES Water to meet its obligations and commitments to customers on the basis of the notional structure. We comment on the financial resilience of the actual structure in section 5.3.

[13] These protections include appointments that confer effective monopolies for specified geographic regions; our commitment to remunerate efficient investment in the RCV as at 31 March 2020; price limit reopeners; inflation indexation; totex cost sharing; allowances for special cost factor claims; outcome delivery incentives; and reconciliation mechanisms for wholesale revenue, the cost of new debt and tax

Our financeability assessment uses a suite of financial metrics based on those used in the financial markets and by the credit rating agencies. The key financial ratios are primarily cash flow measures of a company's earnings, leverage and ability to service its debt interest and principal repayments. We provide further detail of the key ratios in the 'Aligning risk and return technical appendix'.

RCV growth in SES Water's final determination is less than 10%. Therefore consistent with our policy approach set out in the 'Aligning risk and return technical appendix' we apply the base dividend yield assumption of 3.00% with dividend growth of 1.18% for SES Water.

In table 5.2 we set out some of the financial ratios provided by the company in its business plan, and in our draft and final determinations.

Our financial modelling of the notional company suggests that SES Water faces a financeability constraint. Therefore, consistent with the draft determination and with the approach in the PR19 methodology, our final determination increases PAYG rates to bring forward £2 million of revenue to improve cash flows and financial ratios. The financial ratios stated in table 5.2 include the effect of the increase to PAYG rates.

Our in the round assessment of notional financeability is made on the basis of the financial ratios from our financial model. It takes account of the evidence that the company provides regarding the levels and thresholds of the financial ratios that underpinned its assurance statement on notional financeability in its business plan (also stated in table 5.2). We note that the Board assurance statement that accompanied the company's representations was made in the context of the draft determination. Our assessment of notional financeability for the final determination is made in the context of changes made in our final determination. We consider that SES Water'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.

Table 5.2: Ofwat calculation of key financial ratios – notional structure before reconciliation adjustments (5 year average)

	Business plan	Draft determinations	Final determinations
Gearing	60.87%	62.16%	62.18%
Interest cover	4.56	5.00	5.24
Adjusted cash interest cover ratio (ACICR)	1.46	1.46	1.50
Funds from operations (FFO)/Net debt	13.37%	13.29%	13.31%
Dividend cover	2.23	2.35	2.55
Retained cash flow (RCF)/Net debt	11.13%	11.34%	11.48%
Return on capital employed (RoCE)	5.76%	5.53%	5.49%

The basis of the calculation of the ratios is set out in the PR19 methodology.

Net debt represents borrowings less cash and excludes any pension deficit liabilities.

FFO is cash flow from operational activities and excludes movements in working capital.

Cash interest excludes the indexation of index-linked debt.

SES Water's financial ratios in its April business plan tables for the notional company take account of reconciliation adjustments. We set out in the table the ratios excluding these adjustments consistent with our assessment of notional financeability. We verified the recalculation of the ratios with the company.

We set out the average PAYG and RCV run-off rates along with the RCV growth over 2020 to 2025 for SES Water in table 5.3. RCV growth for the final determination is higher than the draft determination although lower than in the company's April 2019 plan. Overall, changes to allowed expenditure, the revised approach to determining the mix of operating and capital expenditure and the uplift to the PAYG rates means less expenditure is added to RCV than in the company's plan. We are not amending SES Water's RCV run-off rates in our final determination.

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

	PAYG	RCV run-off	RCV growth
Company April 2019	49.9%	7.08%	13.81%
Draft determinations	50.6%	7.08%	6.29%
Final determinations	52.4%	7.08%	7.61%
The PAYG and RCV run-off rates are averages across five years and across all wholesale controls. We set out the changes we make to PAYG and RCV run-off rates along with the five year average for each control in section 4.2 and annual PAYG and RCV run-off rates in the 'SES Water - Allowed revenue appendix'. Changes to totex allowances and PAYG rates for individual controls can result in small changes to the average RCV run-off rates presented in the table above.			

In assessing the financeability of the notional company, we consider the headroom available in the final determination to allow the company to continue to meet its annual interest costs. We estimate 5 year headroom of £12 million above an adjusted cash interest cover of 1.0 times, providing headroom to our totex downside of £7 million and outcome delivery incentives downside of £5 million calculated as 1% return on regulatory equity. We set out further detail in relation to our approach to assessing headroom within final determinations in the 'Aligning risk and return technical appendix'.

5.3 Financial resilience

It is the responsibility of each company to choose and manage its financial structure to maintain financial resilience in the long term. A company's financial resilience can be impacted by its financing choices, for example, where a company chooses a structure with a high level of gearing, this can reduce available headroom to withstand cost shocks. Interest costs, levels of dividends paid and company

performance in delivering obligations and commitments to customers can also impact on financial resilience.

SES Water is responsible for the financeability of the company and the maintenance of long-term resilience under its actual structure. We comment further on the financial resilience of the company's actual structure in figure 5.2.

Figure 5.2: Financial resilience of SES Water's actual financial structure

SES Water reported gearing of 60.9% as at 31 March 2019. In its business plan it forecast gearing of 69.1% at 31 March 2021 and 69.8% at 31 March 2025.

SES Water took action to reduce gearing through an equity injection in the year 31 March 2019 and the impact of this is reflected in reported gearing at the year end. That reduction in gearing is not reflected in its business plan therefore the actual gearing for the company is expected to be lower than shown in the forecast above which should allow the company some additional financial headroom.

At the time of our final determination SES Water has a credit rating of Baa1 (negative) with Moody's and BBB+ (stable) with S&P and BBB+ (negative) with Fitch

The Board provided assurance that the company is financially resilient under its plan. The company provided limited further assurance about its financial resilience following the draft determination in the context of its representation.

As stated in section 5.2, we consider the company to be financeable on the notional basis and there is a need for companies to ensure that that they are also financially resilient under their actual structures.

However, we have not accepted all of the company's representations and the allowed return is lower in the final determination reflecting market expectations on the cost of finance.

The company's proposed base dividend for 2020-25 is set out in section 7. When considering the payment of any dividend we expect the Board to take account of the financial resilience of the company.

We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25 to test that adequate steps are being taken by management and that financial resilience is being maintained.

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. SES Water has committed to assess its financial resilience beyond 2025 in its next long-term viability statement.

6 Affordability and bill profile

Key changes from the draft determination

The key changes made to the affordability elements of the draft determination are:

- We revise SES Water's average bill profile from a large reduction upfront followed by flat real terms prices, to have a smaller reduction upfront, followed by a gradually falling real price over 2020-25.

6.1 Bill profile

SES Water proposes an average bill profile with a 7.1% reduction. Our bill profile contains a significantly greater reduction of 15.6% over 2020-25. SES Water does not submit additional evidence on bill profiles or acceptability in its representation.

We are changing our approach to setting average bill profiles from draft determinations, where the majority of companies were set profiles that included upfront bill cuts followed by flat real terms profiles, which would increase in nominal terms once inflation is taken into account. SES Water's bill profile changes to a gradual reduction to provide customers with as much stability as possible in what they actually pay, post inflation (i.e., nominal bills). We set bills in this way for the following reasons;

- Research shows customers prefer consistent, predictable bills;
- Flat nominal bills will help households, particularly those who are financially vulnerable, to plan their finances;
- Profiling in this way is easy to understand and communicate to customers;
- Profiling bills in this way has extensive support from stakeholders including water companies, customer challenge groups and the Consumer Council for Water;
- Company revenues fall less sharply in 2020 with a gradual bill reduction, reducing impact of any step change in allowances.

SES Water's representation contains a bill profile that follows the general path of our final determinations, with an incremental decline in real terms over the period.

Table 6.1: Average bills (2017-18 CPIH deflated)

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company April 2019	£194	£182	£182	£182	£182	£180
Draft determinations	£194	£161	£161	£161	£161	£161
Final determinations – before reprofiling	£194	£174	£173	£172	£169	£166
Final determinations	£194	£178	£174	£171	£167	£164

Throughout the price control we have put a strong emphasis on companies planning for the long-term, both in terms of their goals and their bills. Following actions we set out at initial assessment of business plans, nine companies (SES Water was not one of these) undertook additional customer testing on their long-term bill profiles with several making adjustments as a result. We expect companies to continue to pay attention to this issue, taking customer views into account and planning in a way that ensures they control costs into the future.

6.2 Help for customers who are struggling to pay

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

In addition, SES Water commits to:

- increase the capacity of its social tariff so that it can support 25,000 customers per year by 2024-25;
- increase its social tariff cross subsidy to £6, as supported by customers, and will self-fund part of the extension to its social tariff;
- increase the percentage of customers in debt but making payments from 20% in 2020 to at least 35% by 2025; and
- Re-design and update the eligibility criteria for Clear Start, its payment matching scheme, to help more customers.

SES Water has three bespoke performance commitments on affordability and vulnerability, which will require it to:

- help 25,000 customers through its social tariff schemes;

- increase the awareness of its vulnerability support schemes; and
- maintain 80% customer approval for the notion that its vulnerability support schemes are useful.

Companies will be reporting their performance against the Priority Services Register (PSR) 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 6.2 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 6.2: Allowed revenue by year (£ million, 2017-18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water resources	5.7	5.5	5.4	5.2	5.1	26.9
Water network plus	50.3	50.1	49.9	49.7	49.4	249.4
Residential retail	4.9	5.0	5.1	5.1	5.1	25.2
Total	**60.9**	**60.6**	**60.4**	**60.0**	**59.6**	**301.5**

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

Table 6.3: Base Revenue and K factors by charging year (2017-18 prices)

	Base (£m)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	5.7	0.00%	-2.89%	-2.69%	-3.95%	-2.13%
Water network plus	50.3	0.00%	-0.36%	-0.24%	-0.45%	-0.53%

7 Putting the sector in balance

Key points

- SES Water reported gearing of 60.9% as at 31 March 2019. SES Water forecasts that its level of gearing (69.1% by 2021 and 69.8% by 2025) will be below the level that triggers sharing payments under the gearing outperformance sharing mechanism in 2020-25, as set out in the 'Aligning risk and return technical appendix'. We are updating the gearing outperformance sharing mechanism to introduce a glidepath to the gearing level that the triggers sharing payments as set out in the 'Aligning risk and return technical appendix'.
- Consistent with the lower allowed return on equity in our final determination, we are revising our calculation of the dividend yield as a guide to the reasonable base dividend yield in the absence of out/underperformance in 2020-25. We set out that the acceptable level of base dividend yield can be expected to vary depending on the scale of a company's RCV growth in 2020-25 and future investment needs.
- Our current assessment of the company's proposed dividend policy indicates that the company is falling short in a number of areas and we expect greater transparency from the company when reporting on dividends paid over 2020-25 in the annual performance report.
- On executive pay, SES Water has not provided sufficient information detail to enable the calculation of the overall percentage of alignment to customers, so we are unable to assess how it compares to the 60% alignment to delivery for customers we identify as current good practice. We retain our expectation of the company that it will ensure its dividend and performance related pay policies demonstrate substantial alignment with the customer interest, underpinned by stretching performance targets throughout 2020-25.

In July 2018 we published our 'Putting the sector in balance: position statement'. The position statement sets 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 actual financial structures and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers[14];
- companies with high levels of gearing 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, taking account of their future investment needs.

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

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'.

Our assessment of SES Water's proposals is in table 7.1. We comment on the financial resilience of SES Water in section 5.2.

Table 7.1: Our assessment of SES Water's proposals to balance the interests of customers

Our assessment of the company's proposals to balance the interests of customers
Gearing outperformance benefit sharing mechanism The company has confirmed it would implement our default gearing outperformance mechanism within its business plan, though the company forecasts that its gearing level through 2020-25 will be marginally lower than the threshold that triggers the mechanism.
Voluntary sharing mechanisms SES Water has not proposed any voluntary sharing mechanism. However, the company is increasing the number of customers it supports who are in financial hardship to 25,000 from 19,000 in their original plan, at no additional cost to customers.
Dividend policy for 2020-25 SES Water confirms that it is committed to meet the expectations on dividend policy as set out in our 'Putting the sector in balance' position statement but under our current assessment it falls short in a number of areas as set out below. The company indicates in its September business plan a base dividend yield of 3.8% for 2020-25. We note that that the company states it will expand, agree and publish its dividend policy for 2020-25 in February 2020 and has committed to further illustrate specific obligations and commitments to customers as part of its updated dividend policy once the final determination has been agreed. The company's dividend policy refers to all of the areas included in the 'Putting the Sector in balance' position statement (out/underperformance & benefit sharing, employee interest & pension obligations, actual capital structure, need for future investment and financial resilience). The company confirms that its dividend policy directly links to whether customer pledges and other obligations have been met before dividends are declared, considering actual performance against

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

Our assessment of the company's proposals to balance the interests of customers
regulatory and other commitments but currently provides insufficient detail on the specific obligations and commitments to customers that will be considered. The company confirms that the level of performance delivery considered will be that set out in the final determination. Further correspondence from the company indicates that dividends may be both increased or lowered from the base depending on the actual performance of the company but currently provides insufficient detail on how performance delivery will impact on dividends paid. The company commits to reporting on its dividend policy annually, and confirms that changes to the dividend policy over 2020-25 will be clearly signalled to stakeholders using a range of channels, including Annual Performance Reports. Consistent with the lower allowed cost of equity in our final determination, we have revised our calculation of thedividend yield that we consider to be reasonable for assessing the base dividend for water companies in 2020-25. We consider the acceptable level of base dividend yield is up to 4% but this can be expected to vary depending on the scale of a company's RCV growth and future investment needs. We set out further details in 'Aligning risk and return: technical appendix'. We expect SES Water 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 the final determination 'Aligning risk and return: technical appendix'. Specifically, further transparency needs to be provided on: • the specific obligations and commitments considered under the policy, and • how performance delivery has impacted on the dividends paid.
Performance related executive pay policy for 2020-25 In our 'Aligning risk and return technical appendix' we identify that 60% alignment to delivery for customers is current good practice among the companies that we regulate. SES Water provides insufficient detail to enable the calculation of the overall percentage alignment to customers, so we are unable to assess how it compares to the 60% good practice. We expect SES Water will need to ensure its policy on performance related executive pay will demonstrate a substantial alignment to the delivery of service for customers throughout 2020-25. SES Water states that its Board fully agrees with Ofwat's expectations with regard to transparency about executive pay and in particular any performance related element that is linked to performance for customers as set out in our 'Putting the sector in balance' position statement. It states that there are a number of details to be finalised for its policy for 2020-25, but the company has indicated the following: • the majority of incentives will be linked to delivery of service to customers, including operational performance areas, and will include for example C-Mex, complaints, supply interruptions and other factors that it knows make a real difference to the improvement of its customer service. • metrics will be aligned to its final determination and factors such as year-on-year improvement and industry position, and where required, external benchmarking. In addition the remuneration committee will perform an annual review of the policy to ensure it remains appropriately stretching. Any out performance will only be payable if the company is earning a net reward for the delivery of the customer pledges in any one year. • the remuneration committee will have full powers to determine and recommend to the Board the final awards, including discretionary powers to vary or veto performance awards for exceptional circumstances (such as major reputational issues including a significant safety incident or water restrictions) • gateway provisions will continue in its updated policy to ensure financial performance is not prioritised over outcomes for customers. • a commitment to publishing the executive pay policy for 2020-25 in its annual reports, together with performance results and associated pay awarded through the policy. The final details of the underlying metrics and weightings of the policy, related to the final determination, will be agreed at the remuneration committee meeting in February 2020. Following

Our assessment of the company's proposals to balance the interests of customers
which the company says it will inform Ofwat of its updated policy, ahead of 1 April 2020 when it takes effect. We expect the company's remuneration committee to ensure there is on-going rigorous challenge as to how the policies are applied and to ensure that only truly stretching performance is rewarded. In so doing, we expect it to be equipped with the appropriate powers to carry this out, including for example, the use of withholding periods, clawback arrangements and underpin / gateway arrangements. We expect SES Water to be transparent when explaining and reporting against its performance related executive pay policy in 2020-25, to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in the final determination 'Aligning risk and return: technical appendix'.

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

December 2019

© Crown copyright 2019

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

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

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gov.uk.

OGL