December 2019

PR19 final determinations

PR19 final determinations: South East Water final determination

Ofwat

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About this document

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

The final determination documentation sets out:

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

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 South East 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 South East 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
Table 3.7 Page 39 – Amendment made to figures. • Grants and contributions before the deduction of income offset (£m) Network plus – Water amended from £109.0 million to £108.7 million. • Net allowed totex subject to cost sharing reconciliation Network plus – Water amended from £595.3 million to £595.6 million.	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 particular focus on improved service, affordability, increased resilience and greater innovation. We published our draft determination for South East 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 to be 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 South East Water, covering the customer bill profile, costs, outcomes for customers and allowed revenues.

Bill profile

Our final determination for South East Water will cut average bills by 7.2% in real terms in the 2020-25 period compared to the company's proposed 0.6% reduction. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in April 2019, our draft determination and the final determination. Average bills are lower than proposed by South East 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 1.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan (April resubmission)	£205	£204	£204	£204	£204	£204
Draft determination	£205	£185	£185	£185	£185	£185
Final determination	£205	£198	£196	£194	£192	£190

Costs

Our final determination allows wholesale totex of £917.9 million. This is:

- £32.7 million higher than in our draft determination; and
- £107.0 million lower than stated in the company's representation on our draft determination.

Our final determination allows South East Water £162.4 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £63.7 million to improve the environment by efficiently delivering its obligations as set out in the Water Industry National Environment Programme (WINEP)
- £70.6 million for supply-demand balance schemes delivering long-term drought resilience;
- £10.9 million to improve the resilience of the company's asset systems to maintain the flow of services to customers; and
- £14.9 million to address the impact of deteriorating raw water quality.

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 South East 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 South East Water

Area	Measure
Key common performance commitments	• At least 15% leakage reduction from PR14 performance commitment levels[3] • 7.2% reduction in per capita consumption by 2024-25. • 50% reduction in water supply interruptions by 2024-25. • 2% reduction in unplanned water treatment works from 4.60% in 2019-20 to 2.34% in 2024-25
Bespoke performance commitments	• 32% reduction in the number of contacts, per 1,000 population, received from customers regarding water appearance by 2024-25. • 68% reduction in the amount of greenhouse gas emissions produced per megalitre of treated water 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 -1.80% (P10) to +0.47% (P90).

Note the calculations behind these numbers are outlined in the 'South East 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 'South East Water - Outcomes performance commitment appendix' which relate to this performance commitment reflect that it is measured on a three-year average and show a 9.7% reduction from 2019-20 baseline levels on a three-year average basis.

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

	Water Resources	Network plus - water	Wholesale total	Residential retail	Total
Company view of allowed revenue (£m)	111.6	1,017.3	1,128.9	86.6	1,215.5
Final allowed revenues (£m)	100.3	995.4	1,095.7	88.5	1,184.2

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

As set out in the 'Allowed return on capital technical appendix', we are updating our assessment of the allowed return on capital for South East 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.

South East Water's Regulatory Capital Value (RCV) growth in 2020-25 is 3.1% and 58.7% of its RCV will be indexed to CPIH in 2025. We bring forward £42.3 million of revenue from future periods.

We consider that South East Water's final determination is financeable on the basis of the notional structure, based on a reasonable allowed return on capital and revenue advanced through pay as you go (PAYG) and RCV run-off 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. South East 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, South East Water expects gearing above the level that would trigger sharing payments under the gearing outperformance sharing mechanism in 2020-25. The company proposes to reduce its gearing to around 76% by the end of the period. However the allowed return is lower than our draft determination and this may mean the company needs to take steps to maintain its financial resilience.

To meet our expectations, the company will need to demonstrate that dividends and performance related executive pay polices 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. South East Water does not propose any voluntary sharing mechanism. However, the company does propose company contributions to a hardship fund for customers who may be experiencing short-term or medium-term financial hardship and affordability issues caused through circumstances such as bereavement, job loss or sickness.

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 South East Water in its representation and a summary of our response to each of those points.

Table 1.4: Company representation

Key point in South East Water representation	Summary of our response
South East Water argues that the overall stretch of the draft determination is not realistic and is based on a virtual upper quartile performance that no company can achieve.	Our assessment of cost efficiency takes into account the overall level of stretch across both costs and outcomes. Where appropriate we make adjustments to our approach at draft determination, allowing increased totex, adjusted performance commitments and incentives. We consider that the resulting

Key point in South East Water representation	Summary of our response
	combination of our requirements on both costs and outcomes are stretching but achievable. Evidence suggests that companies can perform well on both costs and outcomes with some companies performing better than the sector-wide benchmarks we set in the 2015-20 price review period. See the 'Policy summary' and 'Securing cost efficiency technical appendix' for more detail.
South East Water retains the totex from its business plan submission, stating that it undertook a full assessment of efficiency when it created its September 2018 business plan and Ofwat's models are less robust than the company-specific assessment. South East Water rejects Ofwat's approach as inconsistent and not robust. It outlines concerns and provides evidence about gaps in expenditure for growth, resilience, leakage and vulnerability.	We review our models and conclude these are stable and appropriate. Companies can raise cost adjustment claims to explain why their efficient costs may not be fully captured in our models. Where this is convincing we make an adjustment. South East Water submits a cost adjustment claim related to our water distribution models. We consider the does not provide convincing evidence for a cost adjustment. We allow an uplift of £7.1m for growth as South East Water is a high growth area. We allow £10.9 million of the £34 million requested in resilience enhancement. The final determination provides an increase above historic level of expenditure, but not to the extent requested (see section 3). We note that South East Water is the only inefficient company in the sector not to revise its view of efficient costs, learning from information revealed in other company business plans and the price review process.
South East Water argues that the draft determination leakage approach does not consider operational realities and ignores the company's good starting position, making improvement difficult without more funding.	As South East Water's leakage performance commitment goes beyond forecast upper quartile, we allow enhancement costs for leakage reduction. We make a leakage enhancement cost allowance of £26.6 million.
South East Water argues that Ofwat understates actual financing costs, for example by relying on current market data. The company considers reducing the allowed return by 37bps to 2.19% causes at least a one notch downgrade in rating for the notional company to Baa2. South East Water asks for a Pay As You Go adjustment of 1.4%, in addition to the 3.4% adjustment requested after the initial assessment of business plans, to maintain financeability on a notional basis. South East Water reduces dividend yield from 2.35% at initial assessment of plans to 1.77%.	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.

Key point in South East Water representation	Summary of our response
The Board of South East Water provides assurance on financeability in its draft determination response, applying the revised allowed return on capital (21 basis points reduction) on the understanding that an additional Pay As You Go adjustment of 1.4 per cent is made and the critical elements of its response are materially accepted as a package. But not in relation to possible further downward movement in the allowed return or further material interventions in Final Determination.	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 accept South East Water's rationale for increasing its Pay As You Go to support financeability though we apply a lower uplift to underlying PAYG rates of 1.96%. We also increase RCV run-off rates by 0.75%. Overall, we bring forward £42.3 million of revenue to ensure the final determination is financeable on a notional basis.
South East Water argues that Ofwat's approach does not link performance commitments and outcome delivery incentives to operating conditions or customer preferences and that this creates risk. The company argues that the draft determination understates the return on regulated equity downside and that South East Water maintaining current performance would attract £68 million penalties. South East Water rejects changes to performance commitments to the compliance risk index, per capita consumption (PCC), supply interruptions and mains repairs. It argues that the calibration of performance commitment levels and incentives provide perverse incentives not to reduce leakage	We amend some performance commitment levels and incentives to better reflect customer preferences, such as accepting the company's proposal to revise the delivery profile for protecting wildlife and increasing biodiversity. We take account of the quality of customer evidence provided in setting our final determination and outcome delivery incentives. We continue to set performance commitments and outcome delivery incentives taking account of sector evidence on company performance. South East Water benefits from sector wide changes for mains repair and supply interruptions levels and amended underperformance payment rates. For per capita consumption (PCC), we change the level of reduction to 7.2% in light of the evidence provided. For compliance risk index, we increase the deadband to 2.0 for all companies to take into account the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court.
South East Water argues that, consistent with C-MeX methodology, the service incentive mechanism (SIM) should include a no payment zone in the calculation of payments for 2015-16 to 2018-19. This would mean that the company would not incur a payment as its score is just above the average.	We consider that our approach for draft determinations remains appropriate. It is consistent with our PR19 methodology and reflects the outcome of our consultation on calculating the service incentive mechanism and the quality of customer service provided by companies.

We also received representations on South East 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 1.5: Stakeholder representations

Stakeholder representations	Summary of our response
The Consumer Council for Water is broadly supportive of the draft determination. It highlights the importance of resilience, arguing that South East Water in a high-growth area and experiencing operational challenges in recent years, and requests that Ofwat allowances use the most up-to-date forecasts for population growth.	We allow additional funding (beyond the allowance from our base models) of £7.1 million for growth as South East Water is a high growth area.

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)	1,102.1	1,184.2
Wholesale cost allowance[1] (£m, 2017-18 CPIH deflated)	885.2	917.9
Retail cost allowance (£m, nominal)	87.2	88.2
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 South East Water are:

- Increasing leakage enhancement allowance from £4.6 million at draft determination to £26.6 million.
- 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 target for mains repairs. We reduce the outcome delivery incentive underperformance rate to industry average.
- 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 amend the deadband on the compliance risk index (which measures compliance with statutory obligations on water quality) 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.
- 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 adjust PAYG rates and increase RCV run-off rates to bring forward £42.3 million of allowed revenue to improve notional financeability. This compares to £27.2 million of PAYG revenue advanced in the draft determination.
- We revise South East Water's average bill profile from a large reduction upfront followed by flat real terms bills, to a smaller reduction upfront, followed by a gradually falling real bill over 2020 – 2025.

2 Outcomes

Key changes from the draft determination

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

- We increase the performance commitment levels for mains repairs as a result of changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction target for mains repairs. We reduce the outcome delivery incentive underperformance rate to industry average. This will provide a more balanced spread of incentives and risks across its performance commitments.
- 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 outcome delivery incentive 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 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. We consider that the water quality compliance risk index is uncertain and all companies should have a collar[4] set in line with our standard approach therefore we are introducing one for this company.

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

[4] Collars are used to limit financial exposure to companies whilst caps are used to protect customers from large bill increases –the collar or cap multiplied by the incentive rate is the maximum underperformance or outperformance payment. Therefore, performance worse than this level (collars) or better than this level (caps) does not increase underperformance or outperformance payments respectively.

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.

South East Water's current performance is average and it has the lowest number of performance commitments met in 2018-19, even excluding the customer satisfaction performance commitments which it considers to be very stretching. South East Water achieved its leakage levels but failed to achieve its supply interruptions levels in 2017-18 and 2018-19.

In its September business plans the company proposed stretching levels for many performance commitments such as leakage but did not show ambition on per capita consumption and proposed a deterioration in mains repairs levels as a result of increasing proactive repairs to reduce leakage. Its outcome delivery incentives were in many cases well evidenced and justified and its overall package was well balanced but we had some concern about the level of customer protection.

Although its April revised business plan amended some common performance commitments, in our draft determination, we intervened in some instances to increase stretch or incentive rates. Our incentive rates interventions were often

related to areas of poor performance. For example, on water supply interruptions we intervened where the rates proposed by the company were low, both in comparison to other companies' at PR19 and its own PR14 rates, and the company's recent performance on this measure was poor. The company did not provide convincing evidence on being able to deliver on its performance commitments for mains repairs and water quality contacts, so we increased incentive rates to protect customers from potential under delivery. We also increased its proposed reduction on per capita consumption to 8% by 2024-25, the high end of the range the company identified in its plan, the company had selected the low end of the range which we considered to be unambitious.

The company representations challenged draft determination decisions in many areas. It argues against our methodology for outcome delivery incentive rates:

- on the use of past performance as a key test, since it considers that performance cannot be compared across companies on asset health and it considers that customer evidence should largely be used.
- on the use of a generic approach to assessing rates which it considers does not reflect each company's specific characteristics, challenges and customer views.

The company also challenges both performance commitment levels and outcome delivery incentive rates on three key areas; compliance risk index, per capita consumption and mains repairs. In addition, it argues current proposals don't incentivise it to improve leakage.

We consider that a company's past performance is relevant to setting outcome delivery incentive rates, since it enables us to consider the need to increase financial incentives to ensure companies place due focus on improving performance in relevant areas. We consider that our methodology uses the reasonable range proportionately, and we conscientiously consider companies' customer research as well as several other factors such as large variance from PR14 rates, comparative performance as well as past performance issues. If the research is considered good quality, it is included in the information we used to set outcome delivery rates (triangulation) on customer facing performance commitments. As such we retain our draft determination decisions for water quality contacts and water supply interruptions - these are two of the performance commitments for which outcome delivery rates were increased for performance related issues at draft determination and which the company noted in its September business plan: '…there are other areas of our service, particularly around our compliance outcomes, where we recognise we need to improve our performance' and 'our performance around larger-scale interruptions is still proving a challenge to reduce'. We amend the rate for mains repairs to reflect an industry wide change relating to the balance of incentives.

On performance commitment levels, we consider the three issues raised below:

- On **compliance risk index**, the company disagrees with our proposed deadband of a score of 2.0 in 2020-21 and 2021-22 and a score of 1.5 in the remaining three years to 2024-25. The company proposes a deadband of 3.7. It claims the measure is volatile, a majority of the industry will fail and hence public perception of water quality will be damaged, the metaldehyde ban has been overturned and a single failure can have a disproportionate impact on a company. As a result of the metaldehyde ban being overturned by the High Court, we amend the deadband to 2.0 across all years. We assess the company data from 2016, 2017 and 2018 and note that the median for these years is 2.83, 2.31 and 2.09. This suggests a deadband of 2.0 is appropriate and the data suggests an improving trend. A deadband set at the levels we are proposing allows for some fluctuation in performance, whilst providing a strong incentive to minimise compliance failures. We consider that the water quality compliance risk index is uncertain and all companies should have a collar set in line with our standard approach. Therefore we add a collar for this company.

- At draft determination we increased the company's percentage reduction in **per capita consumption** from 6.3% to 8%. This was based on the maximum percentage reduction estimated from a study the company had done. The company states that, by using the upper bound of the reduction from its study, we assume every single innovative technique identified works and delivers savings, which is not plausible. We consider that the company's claim is sufficient and convincing in that not all innovations will deliver savings. Therefore we set the reduction at 7.2%, which represents a midpoint between the estimated savings range of 6.3% to 8% and assumes half of all savings will be delivered which we consider to be reasonable. This will allow the company to earn outperformance payments above its performance commitment level to help fund innovation.

- The company considers that the calibration of **mains repairs** with leakage, plus the disallowance of extra money to reduce leakage produces unintended consequences. The company assumes leakage reduction is met mostly through mains repair. The company is concerned that the performance levels required on mains repairs and the interaction with leakage reduction leave it with significant risk of underperformance payments. We increase performance commitment levels for mains repairs by a reducing percentage, for all companies, in all years, reducing the stretch. This will allow all companies 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 intervened in mains repairs levels for this company at draft determinations since it was lagging the sector. We amend the base levels of mains repairs to an average of the best five years'

performance, which provides a more representative level and ensures companies maintain good performance to improve the overall health of their assets over the longer-term.

On leakage, we consider the company's proposed reduction of 9.6% on a three year average basis is appropriately stretching since this delivers at least a 15% reduction on PR14 levels, however the company's revision to its data in its representations causes a minor misalignment with our funding approach. This is because the company is receiving funding for 12.6 Ml/d reduction on an annual basis which is not achieved with the draft determination profile. We have therefore updated the reduction to 9.7% on a three year average basis.

We are also amending the leakage underperformance rate, which the company made representations on. Between the levels that are being funded by enhancement allowances, we are only including the enhancement cost element in this rate and not the foregone marginal benefit element as is usual for outcome delivery incentive rates. This is because we are increasing the company's proposed percentage reduction alongside funding. We do not consider it appropriate to add further underperformance rates for not reaching this very stretching level, beyond recovering the enhancement costs.

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, South East Water provided evidence to demonstrate elements of high-quality customer engagement such as a well-reasoned approach to triangulating its customers' valuations, although we highlighted some areas of concern in our initial assessment of the company's plan, such as insufficient evidence of robust data to support some findings, with views based on qualitative studies alone, with no quantitative data to support findings.

South East Water responded to concerns identified in our initial assessment of the plans by providing further customer engagement evidence about ongoing engagement with customers, use of quantitative data and application of segmentation and, additionally, presents evidence of testing the acceptability and affordability of the next and following price review period plans. We found this research to be of a satisfactory quality.

In its representations to our draft determination, South East Water states that it disagrees with our interventions in relation to outcome delivery incentives and caps and collars4 on the grounds that it is 'disconnected from customer feedback'. As described above in section 2 and in our PR19 methodology, we consider customer research is one of the elements to consider when setting outcome delivery incentive rates and caps and collars but there are other relevant considerations such as past performance. The company states that in relation to water supply interruptions, leakage and water quality contacts, its outcome delivery incentives are not aligned with its customers' valuations (see section above). In some cases, we have amended draft determination decisions to better reflect customer preferences such as accepting the company's proposal to revise the delivery profile for protecting wildlife and increasing biodiversity.

The company additionally states that our intervention in amending the collar for water supply interruptions goes against its customers views. While customer views are important, it is also necessary to consider whether the levels that collars are set at provide appropriate incentives for companies to deliver what customers expect, which includes a resilient service. We consider that the collars proposed by the company would not give sufficient incentive to be resilient. The company does not

address this issue in its response to the draft determination. We continue to set the collar on a multiple of the service level to provide appropriate incentives for companies to improve and have plans in place to be resilient. The company's customer challenge group does not submit any representations to our draft determination.

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

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

The key changes we are making in the final determination are set out in table 2.1[5] below. 'South East Water – Delivering outcomes for customers final decisions' sets out our final decisions in terms of changes to our draft determination for the company's performance commitments and outcome delivery incentives, having considered stakeholder and company representations to our draft determination.

[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.

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 intervened in mains repairs levels for this company draft determinations since it was lagging the sector, setting the level at the average of the best three years' performance. At final determination, we amend the base levels of mains repairs to an average of the best five years' performance, which provides a more representative level and ensures companies maintain good performance to improve the overall health of their assets over the longer-term. We also amended the underperformance payment rate on mains repairs for all companies to industry average.
Adjusting 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. This allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court and also aligns with the median level of current company performance. Introducing a collar set in line with our standard since we consider that the water quality compliance risk index is uncertain and all companies should have a collar.
Accepting the company's proposal to revise the delivery profile for protecting wildlife and increasing biodiversity to better reflect customer preferences.
Profiling the delivery of company sites protected from risk of flooding across the 2022-23 – 2024-25 period and setting linear, interim milestones for years three to five. This will incentivise the company to deliver flood protection benefits as soon as possible to its customers while also enabling the company to carry out the required design and enabling work.
Profiling the delivery of engaging and working with abstractors to improve catchment resilience to low flows across the 2022-23 – 2024-25 period and setting linear, interim milestones for years three to five. This will incentivise the company to deliver environmental benefits as soon as possible while also enabling the company to carry out further enabling work in the pilot catchments and agree baselines with the Environment Agency.
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.
Amending the performance commitment level in relation to per capita consumption from 8% to 7.2% due to further evidence provided by the company on its estimated savings range.
Accepting the company's proposals to change the delivery profile in relation to greenhouse gas emissions because the company provides sufficient justification that this is required to meet procurement timetables.

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) [PR19SEW_A.1]	X		X	
Water supply interruptions [PR19SEW_B.1]	X	X	X	
Leakage [PR19SEW_D.1]	X	X	X	
Per capita consumption [PR19SEW_E.1]	X	X	X	
Mains repairs [PR19SEW_B.2]	X		X	
Unplanned outage [PR19SEW_B.3]	X		X	
Risk of severe restrictions in a drought [PR19SEW_G.1]				X
Priority services for customers in vulnerable circumstances [PR19SEW_J.1]				X
C-MeX: Customer measure of experience [PR19SEW_C.1]	X	X	X	
D-MeX: Developer services measure of experience [PR19SEW_F.1]	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	
Segmented satisfaction of household customers - segment 1 [PR19SEW_C.2]					X
Segmented satisfaction of household customers - segment 2 [PR19SEW_C.3]					X
Segmented satisfaction of household customers - segment 3 [PR19SEW_C.4]					X
Segmented satisfaction of household customers - segment 4 [PR19SEW_C.5]					X
Segmented satisfaction of household customers - segment 5 [PR19SEW_C.6]					X
Segmented satisfaction of household customers - segment 6 [PR19SEW_C.7]					X
Satisfaction of household customers who are experiencing payment difficulties [PR19SEW_C.8]					X
Satisfaction of household customers who are receiving non-financial support [PR19SEW_C.9]					X
Satisfaction of household customers on our vulnerability schemes during a supply interruption [PR19SEW_C.10]					X
Appearance of tap water [PR19SEW_A.2]	X	X	X		
Taste and odour of tap water [PR19SEW_A.3]	X	X	X		
Household customers receiving financial support [PR19SEW_I.1]					X
Satisfaction of stakeholders in relation to assistance offered by South East Water [PR19SEW_J.2]					X
Gap sites [PR19SEW_L.1]					X
Voids – household properties [PR19SEW_L.2]	X	X	X		
Voids – business properties [PR19SEW_L.3]	X	X	X		
Company sites protected from risk of flooding [PR19SEW_B.4]	X			X	
Event Risk Index (ERI) [PR19SEW_B.5]					X
Low pressure [PR19SEW_B.6]	X	X	X		

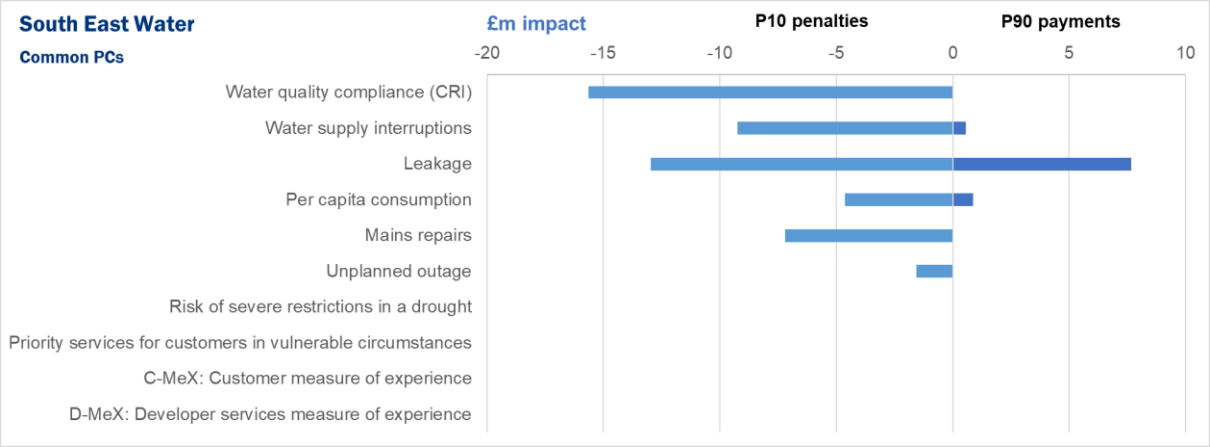
Name of bespoke performance commitment	Type of outcome delivery incentive				
	Financial				Reputational
	Under	Out	In-period	End of period	
Engaging and working with landowners and land managers to improve catchment resilience related to raw water quality deterioration [PR19SEW_H.1]	X	X		X	
Protecting wildlife and increasing biodiversity [PR19SEW_H.2]	X	X		X	
Water Industry National Environment Programme [PR19SEW_H.3]	X		X		
Greenhouse gas emissions [PR19SEW_H.4]					X
Bespoke Abstraction Incentive Mechanism (AIM) [PR19SEW_H.5]	X		X		
Engaging and working with abstractors to improve catchment resilience to low flows [PR19SEW_H.6]					X
Satisfaction with value for money [PR19SEW_C.11]					X
WINEP Delivery [PR19SEW_NEP01]					X
Strategic main Wellwood to Potters Corner [PR19SEW_H.7]	X	X		X	

Figure 2.1 and figure 2.2 provide an indication of the financial value of each of South East 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 payments 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)

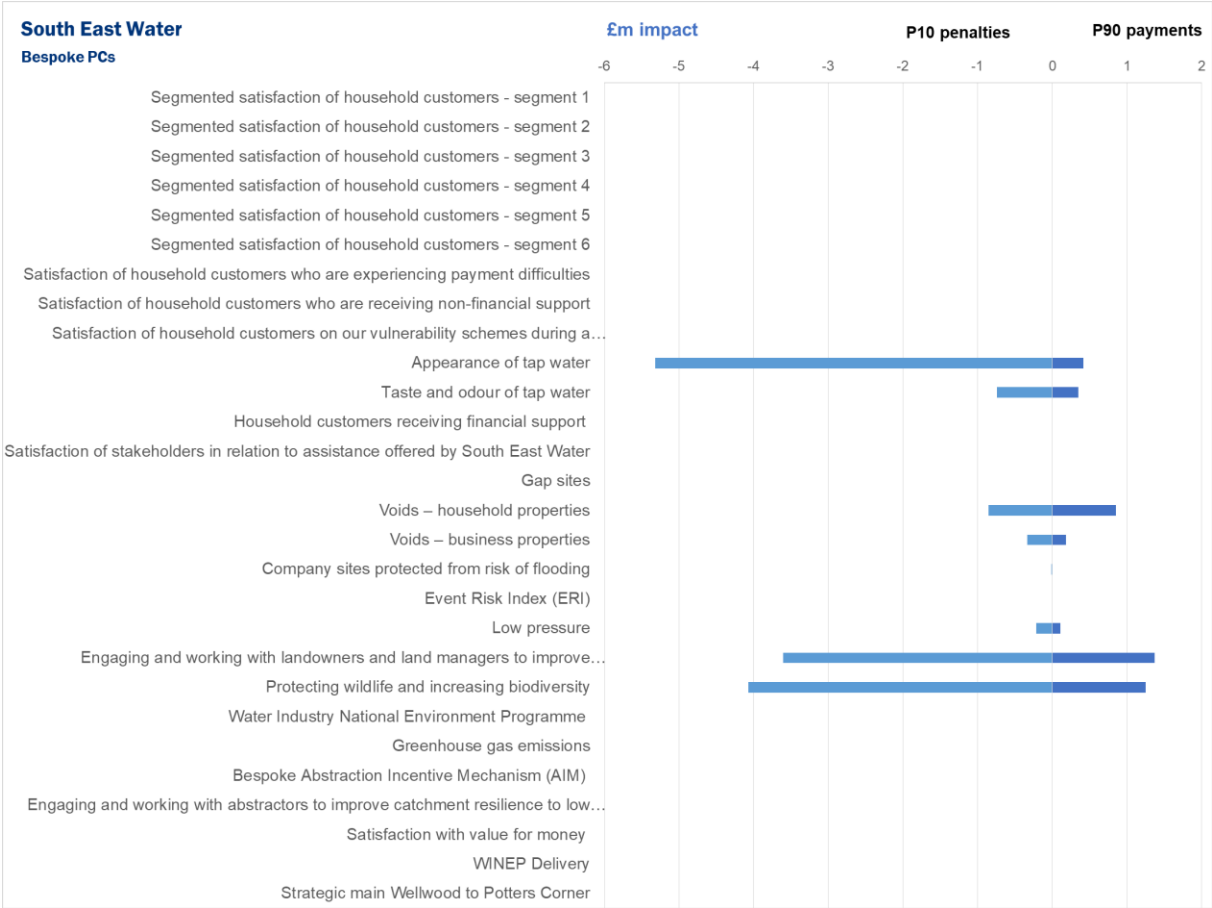


Table 2.4 provides an indication of the financial value of the overall package at the upper and lower extreme levels of performance (expressed as a percentage point impacts on RoRE (return on regulatory equity)) and the overall impact of our final determination decisions. Further information on how we 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
South East Water	-2.40	+0.27	-1.8	+0.47

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) 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 PR19 methodology. Overall, South East 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 consider a wide range of mitigation options, covering traditional

engineering, nature-based and behavioural options. The company's business plan also provides a sufficient assessment of operational, corporate and financial risks.

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 South East Water an action (SEW.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.

Overall, South East Water's resilience action plan includes a number of good elements but falls short of our expectations in other areas.

The company's action plan meets our expectations in the following areas:

- it provides good evidence of risk identification and prioritisation, clearly demonstrating how risks are assessed, escalated and prioritised in practice;
- the company provides clear and comprehensive response to feedback from our initial assessment of business plans, demonstrating how some elements of a systems-based approach are already applied; and
- the company provides evidence it has considered a broad range of mitigation options following the 4R's approach to resilience of resistance, reliability, redundancy, and 'response and recovery'.

South East Water's action plan falls short of our expectations in some areas. In particular, the company's action plan is not informed by a baseline maturity assessment. South East Water identifies this as a future action, however, we expect the company to clearly demonstrate how its action plan is influenced by an understanding of its baseline maturity.

Overall, South East 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 South East Water is £917.9 million for the wholesale services. This compares with £885.2 million at draft determination. In retail, our final determination allowance is £88.2 million, compared with £87.2 million at draft determination.
- Our base allowance is affected by a number of changes we have made since draft determinations:
  - we include company out-turn 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.
- We make a £7.1 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 a more meaningful, trusted relationship with customers.

South East Water submitted a business plan for 2020-25 with expenditure proposals that are about 15% above what it has incurred historically. We consider that the company's expenditure proposals for wholesale services are inefficient. We challenge South East Water's proposed costs to ensure customers pay only for efficient costs. At draft determinations, the company had a large cost gap. Further to

our review of South East Water's representations on our draft determination and the resulting additional cost allowances that we make, the gap at final determination has reduced from £133 million (12%) to £100 million (9%).

We consider the company's requested costs in residential retail are efficient. We make an allowance greater than it requests in this area.

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

In the 'South East Water – Cost efficiency 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 decision on 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	26.0	24.3	23.9	22.0	21.9	118.1	130.1
Water network plus	147.9	164.6	169.1	157.1	161.0	799.8	894.7
Total	**173.9**	**189.0**	**193.0**	**179.1**	**182.9**	**917.9**	**1,024.9**

[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 costs (excluding enhancement opex), 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'. We use the adjustment to operating costs that the company proposed 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 by wholesale price control and type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Water resources	Water network plus	Total
Base expenditure	75.0	661.2	736.2
Enhancement expenditure	40.8	121.7	162.4
Operating lease adjustment	-0.2	-0.7	-0.9
Gross allowed totex used to calculate cost sharing rates	115.6	782.2	897.7
Strategic regional water resources solutions and other cash items	-	-	-
Third party costs	-	2.2	2.2
Non-section 185 diversions	-	0.4	0.4
Ex-ante cost sharing adjustment	-	-	-
Gross totex	115.6	784.8	900.3
Grants and contributions after adjustment for income offset[1]	-	87.7	87.7
Net allowed totex used in PAYG calculation	**115.6**	**697.1**	**812.6**
Pensions deficit recovery costs[2]	2.5	15.0	17.5
Total	**118.1**	**712.1**	**830.1**

[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 in the amount stated in table 3.2. Our draft determinations allowance did 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	1,005.1	1,004.7	866.4	898.6

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

	Draft determination allowance	Final determination allowance
Base expenditure	688.4	736.2
Enhancement	177.9	162.4
- Environmental obligations (WINEP)*	67.3	63.7
- Supply-demand balance and metering enhancement	49.6	71.2
- Resilience enhancement	3.5	10.9
- Other enhancement (e.g. raw water deterioration)**	57.5	16.6

*At draft determination the figure includes £1.7 million for 'Improving river flows'. At final determination this allowance is included in the 'Other enhancement' line instead.
**At draft determination the figure includes an additional allowance of £41.8 million we made for growth. At final determination this allowance is included in our base allowance instead.

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	Final determination allowance
Water Resources	83.7	75.0
Water Network plus	659.8	661.2
Total	**743.5**	**736.2**

Note 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 also make 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 consider that the models over-compensate 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 for South East Water 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 £7.1 million. More details of our approach can be found in the 'Securing cost efficiency technical appendix'.

The company makes two representations on our approach to growth costs. The first is a cost adjustment claim of £23 million related to atypical on-site and off-site reinforcement costs. The second relates to our decision to apply a 75% developer recovery rate to intra-zonal schemes, which the company argues would not be recoverable from developers. We reject these representations. The company does not provide sufficient evidence that it faces unique circumstances to justify an additional adjustment to our modelling result; and we consider that the intra-zonal schemes are directly related to population growth and the company can expect to recover a significant proportion of the costs from developers. We provide further details of our assessment in the 'South East Water – Cost efficiency additional information appendix'.

South East Water disagrees with our approach of not making an allowance for changes in business rates due to revaluations. We recognise the uncertainty and limited company control over the level of business rates after a revaluation. For final determinations, we maintain our approach to setting business rates allowances without an allowance for revaluations but, to address the risk and limited controllability, we allow for an uncertainty mechanism – see section 4.4.5 for more

details. Our approach to setting allowances for business rates is set out in the 'Securing cost efficiency technical appendix'.

In its representation on pension deficit repair costs, South East Water argues that it is inappropriate to apply further efficiency challenges as it has made all efficiencies that it can and that our calculation assumes a cumulative efficiency. However, we apply the same efficiency challenge to each year's allowance which is consistent with our information notice we published in 2013, IN13/17. Our efficiency challenge is not cumulatively applied. At PR09 South East Water's pension deficit repair contribution schedule included a year-on-year inflation assumption. We continue to remove this for final determinations as we did at PR09 and PR14 since inflation is applied to price limits each year.

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	44.0	40.8
Water Network plus	217.3	121.7
Total	**261.2**	**162.4**

Our final determination allows South East Water £162.4 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £63.7 million to improve the environment by efficiently delivering its obligations as set out in the whole WINEP programme
- £70.6 million for supply-demand balance schemes delivering long-term drought resilience;
- £10.9 million to improve the resilience of the company's asset systems to maintain the flow of services to customers; and

- £14.9 million to address the impact of deteriorating raw water quality.

The most material areas of enhancement cost challenge for South East Water include: the WINEP, the resilience programme, components of the supply-demand balance programme and the wholesale costs for vulnerable customers.

Below we discuss key areas of our determination on enhancement cost proposals. Our document 'South East Water - Cost efficiency final determination appendix' sets out in more detail the costs forecast by the company in its August 2019 submission and our allowances by investment area for each price control. We give full reasoning in our published cost assessment models (enhancement feeder models and cost claims feeder models).

South East Water's total enhancement allowance appears lower than at draft determination because the £41.8 million allowance we make for intra-zonal growth we now allocate to growth as an addition to our base plus modelling, rather than allocating it to enhancement as we did at the draft determination. If we remove this growth allowance from our draft determination figures, our enhancement allowance has increased by £26 million for final determination.

WINEP

South East Water includes total forecast expenditure of £69 million in its August 2019 submission to deliver its WINEP obligations. Our final determination allowance of £64 million has decreased from the £67 million we allowed at the draft determination because of a change to the company efficiency factor that we apply in our shallow dive and deep dive cost assessments. South East Water is now assessed as less efficient than it was at draft determination. We explain how we calculate efficiency factors in the 'Securing cost efficiency technical appendix'.

In cost terms South East Water proposes the largest programme of investigations and options appraisals in 2020-25 of any water company to carry out its WINEP obligations. We accept the need for these activities. However, while the company's representation on the draft determination provides additional evidence to demonstrate the robustness and efficiency of its cost estimates, we find no external assurance and some data inconsistencies. We expect the company to be able to make further savings and we retain the efficiency challenge we applied at draft determination.

Resilience

Our draft determination made a £3.4 million allowance to South East Water to: mitigate failure of a critical main from Arlington water treatment works and; to protect its sites from pluvial and fluvial flooding. We did not make an allowance to mitigate asset failure at Barcombe and Oakhanger water treatment works. We also did not make allowances for mitigating supply risk at: Wellwood service reservoir and Potters Corner, Greywell water treatment works and Cliddesden.

In its representations to the draft determination, South East Water proposes £34.0 million of investment in water resilience enhancements. The company does not raise substantive issues on its draft determination allowances for: pluvial and fluvial flood protection and mains failure from Arlington. We maintain our draft determination allowances for these proposals.

We partially accept the need to mitigate asset failures at Barcombe water treatment works. The company provides in its representation sufficient evidence to demonstrate that failure of a critical asset at the treatment works presents a single point of failure risk that would result in long duration supply interruptions to customers. However, there is insufficient evidence to demonstrate that its proposed mitigations relate to this risk rather than process maintenance activity covered by our base allowance. We make an allowance of £0.8 million for cross-connection between the treatment streams and upgrade of the high lift pump station on treatment stream one to mitigate the single point of failure risk.

We do not accept the need for investment at Oakhanger water treatment works. There is insufficient evidence that the risks posed by the capacity of treatment assets within the works are low probability or result in high consequence events for customers. Furthermore, there is no evidence to demonstrate the likelihood of critical asset failures within the system supplied by this works.

We accept the need for investment to mitigate mains failures between Wellwood service reservoir and Potters corner. There is insufficient evidence to demonstrate that a water treatment works outage is beyond management control. However, there is sufficient evidence to demonstrate that mains failure is a low probability event which is beyond management control and would result in an extended supply interruption. We apply a benchmarked unit cost rate to determine our allowance. We make an allowance of £6.5 million for delivery of 60% of the investment during 2020-25 with appropriate customer protection against non-delivery. The remaining 40% of the investment will be delivered during 2025-30.

We do not accept the need for investment for a new main between Greywell water treatment works and Cliddesden service reservoir to mitigate the risk of mains failure or water treatment works outage impacting customers supplied by Cliddesden service reservoir. There is insufficient evidence to demonstrate that a failure of the main or water treatment works outage would result in an extended interruption of supply to customers.

As a result of the above, our final determination allowance for water resilience enhancement is £10.9 million.

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 South East Water, we allow some funding under enhancement, for the volume of leakage reduction it will deliver beyond the forecast upper quartile threshold. We use the leakage reduction unit cost the company identifies and apply the company-specific efficiency factor to make our allowance. The final determination allowance for this component increases from £4.6 million at draft determination to £26.6 million at final determination following our revised assessment approach (compared with the company's requested totex of £29.6 million). In the '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 therefore increase the total supply-demand balance allowance we make from £49 million at draft determination to our final determination allowance of £71 million (compared to the company's requested totex of £76 million).

Water resource investigations and future planning

The company makes no changes to its requested allowance for investigations and future planning from draft determination, £1.7 million, and represents that it still considers this activity as enhancement being the planning phase of future projects. Our position is unchanged from draft determination in that we consider that the activities identified by the company in this component are adequately funded through the base allowance. South East Water does not provide sufficient evidence to demonstrate any unique or company-specific circumstances that we would consider justify making an enhancement allowance for this component.

Supporting vulnerable customers

South East Water proposes investment of £4.2 million, largely to provide non-financial support to vulnerable customers during supply interruption incidents. We note the company's poor performance during the 2018 freeze/thaw event and the commitments made by South East Water to improve service by the end of the 2015-20 period. We recognise the importance of supporting vulnerable customers and note South East Water's stretching target for its Priority Service Register reach. However, this expenditure is part of a company's business as usual work and as such is covered in our base allowance. We note that a material proportion (43%) of the expenditure is earmarked for delivering bottled water to customers on the Priority Service Register during a supply interruption. No other company requests enhancement funding of this nature and yet all companies are required to provide such a service. We do not consider it appropriate to make an extra allowance to South East Water for these costs.

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. For final determination we introduce an uncertainty mechanism for business rates and abstraction charges. Under the uncertainty mechanism these

costs are subject to different cost sharing rates. We discuss the uncertainty mechanism in section 4.4.5. Our allowance for business rates and abstraction charges costs are excluded from table 3.7.

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	127.6	877.0
Totex for cost sharing rates – August 2019	127.6	877.0
Weighted company view of totex for cost sharing rates	127.6	877.0
Gross allowed totex for cost sharing rates	115.6	782.2
Cost sharing ratio	1.12	
Cost sharing rate – outperformance	38%	
Cost sharing rate – underperformance	62%	
Grants and contributions	-	108.7[6]
Abstraction charges and business rates	18.4	77.9
Net allowed totex subject to cost sharing reconciliation with standard cost sharing rates in this table	97.1	595.6[7]

3.5 Allowed expenditure in residential retail

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. These costs have been wholly allocated to wholesale controls.

Based on our benchmarking analysis, we assess South East Water's cost proposals for 2020-25 in residential retail as efficient. As a consequence of our overall approach, which rewards efficient business plans, South East Water receives a higher expenditure allowance than it requests in its business plan.

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

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

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	17.3	17.5	17.6	17.8	18.0	88.2
Company view	16.0	16.2	16.4	16.6	16.6	81.8

Note the residential retail control is an average revenue control. Allowed cost and the associated allowed revenue is based on a forecast of the number of customers. There will be an end-of-period true up based on the actual number of connected households.

3.6 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.

There is sufficient evidence that there are currently no suitable projects for a direct procurement for customers' process within South East Water's business plan for the period 2020-25. We accept that the Bewl-Darwell Transfer scheme and the Aylesford Newsprint water treatment works scheme are likely to offer greater value for customers if delivered through a traditional in-house procurement process.

We expect that both the proposed New Arlington reservoir and Broad Oak reservoir for 2025-2030, or similar sized alternative schemes, will be progressed through a direct procurement for customers process.

We also expect any other major schemes which may arise due to significant changes to South East 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 South East 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 £1,184.2 million of revenue across all price controls for South East Water in the final determination, compared to £1,102.1 million in the draft determination and £1,215.5 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.
- Consistent with the draft determination, we make a technical intervention to PAYG rates to maintain South East Water's approach and take account of our view of the mix of operating and capital expenditure. We also revise our approach to determining this mix to take better account of the nature of our interventions to cost allowances.
- We adjust PAYG rates and increase RCV run-off rates to bring forward £42.3 million of allowed revenue to improve notional financeability. This compares to £27.2 million of PAYG revenue advanced in the draft determination.
- Allowed revenue includes South East Water's contribution to the innovation competition.
- We revise our approach to calculating grants and contributions.
- We reflect South East Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission and 30 August representation.
- Our final determination includes finalised scores for 2018-19 in the residential retail service incentive mechanism. This increases revenue by £0.4 million compared to the draft determination.

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 South East Water's wholesale controls in table 4.1. We summarise the total of the build up of allowed revenue as five year totals, however our financial model calculates the allowed revenue on an annual basis for the purposes of our draft determination. We state the allowed revenue for each price control on an annual basis in section 6.

We explain how we calculate PAYG, RCV run-off and the allowed return on 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	70.8	496.9	567.7	521.4
RCV run-off	18.3	231.8	250.1	233.3
Allowed return on capital	10.8	154.2	165.0	181.2
Revenue adjustments for PR14 reconciliations	0.0	10.8	10.8	13.7
Fast track reward	0.0	0.0	0.0	0.0
Tax	0.6	16.2	16.8	13.3
Grants and contributions after adjustment for income offset (price control)	0.0	87.3	87.3	57.8
Deduct non-price control income	-0.1	-5.3	-5.5	-5.5
Innovation competition	0.0	4.0	4.0	0.0
Revenue re-profiling	0.0	-0.4	-0.4	0.2
Final allowed revenues	100.3	995.4	1,095.7	1,015.3

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'South East Water - Allowed revenue appendix' in tables 1.1 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 South East 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[8], 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.

[8] 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 South East 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)	1,052.2	1,113.6
Proportion of wholesale revenue allocated to residential (%)	77.7%	77.7%
Residential retail costs (£m)	87.2	88.2
Total retail costs (£m)	**904.7**	**953.4**
Residential retail net margin (%)	1.0%	1.0%
Residential retail net margin (£m)	**9.1**	**9.6**
Residential retail adjustments (£m)[1]	-0.8	0.0
Residential retail revenue (£m)[2]	**95.5**	**97.9**

[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 'South East Water - Allowed revenue appendix' in table 1.3.

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

Our totex cost allowances are sufficient to meet an efficient company's operating and capital expenditure. Companies recover this expenditure either in period from current customers using PAYG or add it to the RCV and recover from future generations of

customers using the RCV run-off rates. Consistent with our methodology, we assess how each company's choice of PAYG and RCV run-off rates reflect the levels of proposed expenditure, bill profiles, affordability and customer views relevant to the short and the long term.

To determine the allowed revenue, the PAYG rate is applied to the totex allowance for each wholesale control for each year of the price control. The proportion of the totex allowance that is not recovered in PAYG is added to the RCV and recovered from customers in future periods. 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 the '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 4.3 the average PAYG rates across 2020-25 for each wholesale control, and the calculation of total PAYG revenue. The PAYG rates shown in the table are a weighted average across the five years 2020-25, the annual PAYG revenue and PAYG rates for each wholesale control are shown in the 'South East Water - Allowed revenue appendix', tables 2.1 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)	115.6	697.1	812.6
Final determination PAYG rate (%)	59.1%	69.1%	67.7%
Pay as you go totex (£m)	68.3	481.9	550.1
Pension deficit recovery cost (£m)	2.5	15.0	17.5
Total pay as you go (£m)	**70.8**	**496.9**	**567.7**

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

	Water resources	Water network plus
Original company plan (%)	60.1%	60.9%
Draft determination (%)	61.3%	62.4%
Final determination (%)	59.1%	69.1%

In the draft determination, we applied South East Water's approach to PAYG rates to recover in each year an amount equivalent to operating costs plus infrastructure renewal 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 accepted the uplift to PAYG rates of on average 3.4% for all controls proposed in the company's April revised business plan to improve notional financeability. The uplift brought forward £27.2 million of PAYG revenue in the draft determination.

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.

In its representations, South East Water states that if the final determination includes the cost of capital applied in the draft determination, the company requires a further uplift of 1.4% to PAYG rates (4.8% PAYG adjustment in total) to improve notional financeability.

Our final determination includes a lower allowed return than in the draft determination, reflecting market expectations. Following our assessment of notional financeability for the final determination, we accept the requirement for further revenue advancement than set out in the draft determination.

We are increasing the amount of revenue brought forward to £42.3 million to increase cash flows in the 2020-25 period to improve notional financeability. However, South East Water has the lowest RCV run-off rates in the sector and the company sets out that it may review the method of setting RCV run-off in future price reviews, we consider it is appropriate to apply part of the adjustment to RCV run-off rates. This aligns more closely with the notional financial ratios targeted by the company in its business plan. We set out our adjustments to RCV run-off rates in section 4.2.4. Therefore, we reduce the uplift to PAYG rates for all years for all wholesale controls from 3.40% in the draft determination to 1.96% which brings forward £16.7 million of allowed revenue from future periods. We set out our financeability assessment in section 5.2.

The movements in PAYG rates between the original 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 different PAYG adjustments for notional financeability in the business plan and draft determination compared to the final determination.

4.2.2 Opening RCV adjustments

As part of its business plan South East Water proposed an allocation of the RCV for the water resources price control based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale control and water resources in accordance with the proportions proposed by South East Water.

We make reconciliation adjustments ('midnight adjustments') related to the company's performance against incentive mechanisms from previous price reviews and for land sales in order to determine the opening RCV for the period of the PR19

controls. We also adjust the RCV upwards to reflect a change in the accounting treatment of leases, which causes some assets formerly recognised as operating leases to be recognised on the company's Balance sheet. In doing so, we follow the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. We use the adjustment proposed in the company business plan.

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

	Water resources	Water network plus
RCV – 31 March 2020	1,355.9	
% of RCV allocated by control	5.00%	95.00%
RCV – 31 March 2020	67.8	1,288.1
Midnight adjustments to RCV	-2.1	-39.4
Midnight adjustments relating to operating leases	0.5	2.0
Opening RCV – 1 April 2020	66.2	1,250.7

4.2.3 Allowed return on capital

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

South East Water's business plan incorporates the early view allowed return on capital for the wholesale price controls of 3.30% - CPIH deflated (2.30% - RPI deflated) that we state in the PR19 methodology. 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	33.1	625.4	658.5
CPIH inflated RCV	33.1	625.4	658.5
Other adjustments	-	-	-
Total RCV	**66.2**	**1,250.7**	**1,316.9**

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	28.3	532.3	560.7
CPIH inflated RCV	28.1	529.6	557.7
Post 2020 investment	40.1	198.7	238.8
Other adjustments	-	-	-
Total RCV	**96.6**	**1,260.6**	**1,357.2**

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	2.9	55.6	58.5
CPIH inflated RCV	4.5	84.1	88.6
Post 2020 investment	3.4	14.5	17.9
Other adjustments	-	-	-
Allowed return on capital	**10.8**	**154.2**	**165.0**
Company (April 2019) – return on capital	12.7	188.3	201.1

Note 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 'South East 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 controls, for post 1 April 2020 investment. Table 4.9 sets out the resultant RCV run-off revenue for each component of RCV for each wholesale control.

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

	Water resources	Water network plus	Total
CPIH inflated RCV	5.0	95.8	100.7
RPI inflated RCV	6.2	119.5	125.7
Post 2020 investment	7.2	16.5	23.7
Total RCV run-off	**18.3**	**231.8**	**250.1**

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

For the draft determination, we applied South East Water's RCV run-off rates which are based on average lives for assets within each wholesale control. South East Water does not make any representations in relation to RCV run-off rates and we continue to apply the company's approach to setting RCV run-off rates for the final determination.

South East Water has the lowest average RCV run-off rates amongst all of the water companies. The company uses average asset lives to determination its RCV run-off rates and South East Water sets out the low RCV run-off rate may be due to this method of determination. In its April revised plan, the company states that there are alternative valid methods for estimating the RCV run-off rate, including an assessment of future maintenance expenditure needs and it may be appropriate to review alternative methods of setting RCV run-off rates to ensure that an appropriate balance between PAYG and RCV run-off rate is maintained. Therefore, we consider it appropriate to apply part of the revenue advance required for financeability using the RCV run-off rates. We consider our approach to using both PAYG and RCV run-off levers to bring forward revenue maintains this balance. We also consider this aligns more closely with the notional financial ratios targeted by the company in its business plan. We amend the PAYG uplift as set out in section 4.2.1 and increase RCV run-off rates for all years and all controls by 0.75% to increase cash flows in the 2020-25 period. The RCV run-off adjustment brings forward £25.6 million of allowed revenue from future periods.

We set out our financeability assessment in section 5.2.

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) (%)	3.97%	3.28%
Draft determination (%)	3.91%	3.28%
Final determination (%)	4.23%	3.63%

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

The annual rates for each wholesale control are set out in the 'South East Water - Allowed revenue appendix' in tables 5.1 and 5.2. Changes to totex allowances and PAYG rates for individual years can result in small changes to the average RCV run-off rates. The increase in RCV run-off rates between the final determination and the company plan and draft determination reflect the increase applied to RCV run-off rates for financeability.

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. 'South East 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 'South East Water - Accounting for past delivery appendix' sets out how these adjustments are allocated across controls and how the RCV adjustment feeds into the midnight adjustments to RCV set out in Table 4.5.

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	No interventions required.
Residential retail revenue	We are intervening to change 'Actual customer numbers - Unmetered water-only customer' in 2018-19 from 106,515 to 106,678 and 'Actual customer numbers - Metered water-only customer' from 754,252 to 754,844 consistent with the company's 2019 annual performance report. We are including a figure of 3.74% for the 'Materiality threshold for financing adjustment - Discount Rate' in line with the 'PR14 reconciliation rulebook'. We are making these interventions relative to the company's 15 July 2019 submission. These interventions are consistent with the company's view in its representation. Our intervention increases the total residential retail revenue payment at the end of the 2015-20 period from £0.636 million to £0.651 million.
Wholesale revenue forecasting incentive mechanism	No interventions required.
Totex	We are intervening to change the 'Water: Implied menu choice' figure to full decimal accuracy as calculated in the PR14 populated final determination models. Our intervention reduces the water totex RCV adjustment from - £18.059 million to - £17.899 million and reduces the water totex revenue adjustment at the end of the period from - £4.927 million to - £4.907 million.
Land sales	No interventions required.
Residential retail service incentive mechanism	We are intervening to set South East Water's residential retail service incentive mechanism adjustment to - 0.45% of residential retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to -£0.510 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	-0.4	-0.4	-1.0	-1.0
Residential retail revenue	N/A	N/A	0.6	0.7
Wholesale revenue forecasting incentive mechanism	N/A	N/A	18.0	18.0
Totex	-18.1	-17.9	-4.9	-4.9
Land sales	0.6	0.6	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	0.0	-0.5
PR09 blind year adjustments2	-23.7	-23.7	0.2	0.2
Water trading	N/A	N/A	0.0	0.0
Other adjustments	0.0	0.0	0.0	0.0
Total	**-41.6**	**-41.5**	**12.9**	**12.4**
Total post profiling[3]	**N/A**	**N/A**	**13.8**	**13.2**

[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 'South East 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	0.0	0.0	0.0
Tax	0.6	16.2	16.8
Grants and contributions (price control)	0.0	87.3	87.3
Deduct non-price control income	-0.1	-5.3	-5.5

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'.

South East 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.

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

	Water resources	Water network plus	Total
Tax	0.6	16.2	16.8

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 (price control)

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 the '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. This includes a one-off contribution of £31.4 million that South East Water did not originally include within grants and contributions in its business plan:

- South East Water included £58 million as supply-demand balance expenditure despite it being related to intra-zonal schemes (rather than inter-zonal). The expenditure is also largely linked to areas with high development. After considering the evidence South East Water present in their business plan we allowed £41.8 million for these schemes through a base cost adjustment.
- Our view is that a 75% recovery rate is appropriate as we consider intra-zonal schemes expenditure is directly connected with high growth. As such we think it is appropriate that the company should expect to recover a significant proportion of this expenditure from developers. We, therefore, include a one off contribution of £31.4 million in the table below.

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

	Water resources	Water network plus	Total
Grants & contributions (before deduction of income offset allowances)	0.0	108.7	108.7

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	87.3	87.3

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	0.4	0.4

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	-0.1	-5.3	-5.5

Note negative numbers represent a deduction from the allowed revenue.

4.4.4 Uncertainty mechanisms

Given the range of risk mitigation measures included in price controls, the PR19 methodology said that final determinations would only include bespoke uncertainty mechanisms where robust and compelling evidence was presented for that item. South East Water does not propose any uncertainty mechanisms.

We are including a PR24 reconciliation mechanism for business rates in our final determination for South East 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 South East Water along with all other companies serving England[9] 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.

[9] 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 South East 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 £42.3 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.

South East Water is responsible for ensuring it delivers its obligations and commitments in the context of its choice of capital and financing structure. The company proposes to remain highly geared in 2020-25. South East Water may need to take further steps to improve its financial resilience. 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 South East 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 company 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[10].

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[11]. 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 South East Water in our final determination. The risk ranges show the plausible range of company returns based on South East 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

[10] 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.

[11] 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.

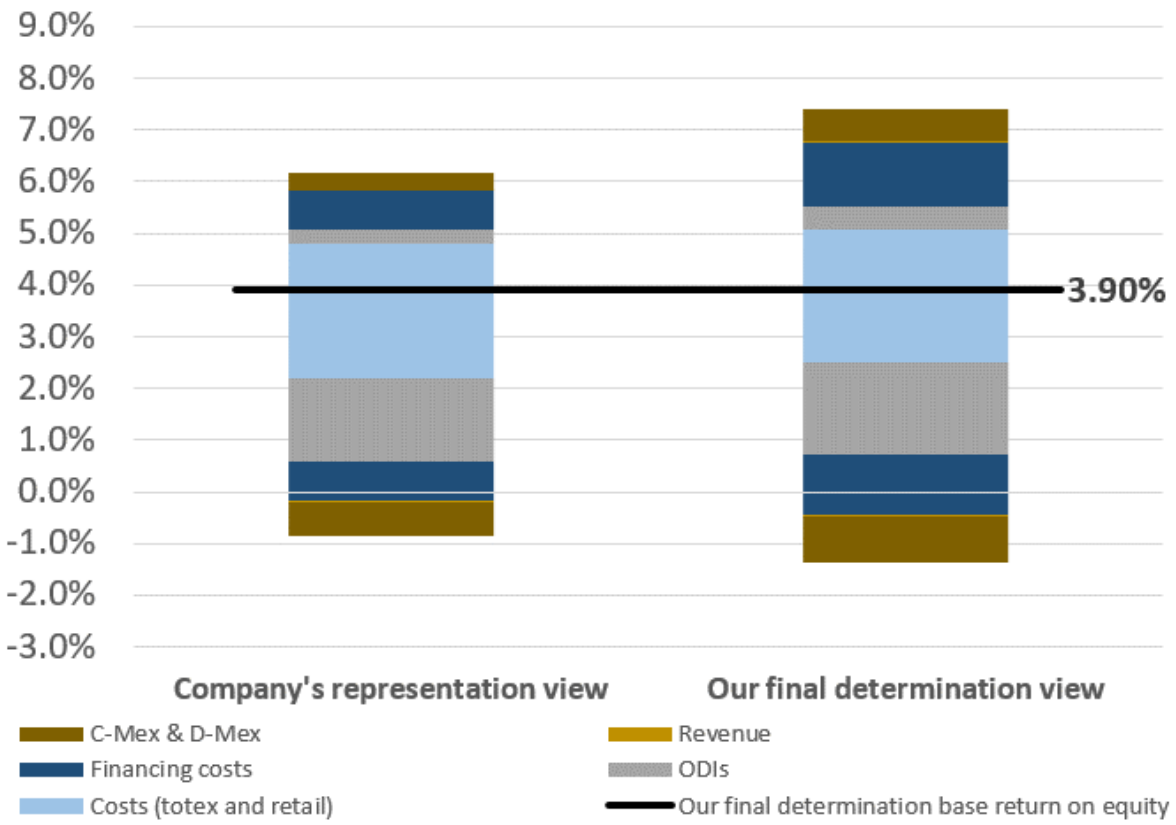
South East Water has a significant scope to earn upside from outperformance as well as the risk of lower returns from underperformance with modest negative skew overall to its overall risk range, driven primarily by outcome delivery incentives. Our view is that an efficient company should be able to 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 asked companies to update their risk ranges in their representations. 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: South East Water final determination risk ranges

	Range implied in company representation		Final determination ranges	
Base RoRE	-		3.90%	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-1.47%	0.67%	-1.18%	0.95%
Outcome delivery incentives	-1.63%	0.27%	-1.80%	0.47%
Financing costs	-0.73%	0.73%	-1.16%	1.23%
Retail costs	-0.24%	0.24%	-0.22%	0.22%
C-MeX and D-MeX	-0.66%	0.33%	-0.88%	0.64%
Revenues (includes Retail)	-0.05%	0.01%	-0.05%	0.01%
Total	**-4.78%**	**2.25%**	**-5.28%**	**3.51%**

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 South East Water



Note 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 South East 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 business plan, South East Water sets out that its 'Business plan will, over the next control period and in the long term, enable the company to fulfil its statutory and legal obligations, remain resilient – operationally, financially and corporately and meet the expectation of the UK government's strategic policy statements'. The company states that its plan targets a credit rating of Baa1 on a notional basis and Baa2 on the basis of the actual capital structure.

Subsequently, we asked companies to provide additional Board assurance, in their representations in response 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.

South East Water sets out a proposal in its April business plan to increase PAYG rates by 3.4%. In the draft determination we accepted the company's proposal to increase PAYG rates to improve notional financeability. The company sets out that certain rating agencies reverse revenue advanced in their calculation of adjusted interest cover ratios, however the increase to PAYG revenue improves other financial ratios. In its representations South East Water proposes a further increase of 1.4% on the basis of the lower return on capital to support notional financeability.

The company includes a third party report that suggests notional financeability could be improved using an adjustment to PAYG and an additional increase to RCV run-off rates. In its representations the company proposes using only a PAYG adjustment for simplicity and to avoid changes to asset values and depreciation asset lives that underpin the calculation of the natural RCV run-off rate. However, South East Water set out it may review its approach to setting RCV run-off rates in response to low returns in future price reviews.

We have carefully considered the representations made by South East Water including the qualifications attached to 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[12]. 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 South East 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.

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 South East 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 South East 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 after removing any adjustments to PAYG and RCV run-off rates suggests that South East Water faces a financeability constraint. Therefore, consistent with the approach in the PR19 methodology, we bring forward £42.3 million of revenue to improve cash flows and financial ratios. As set out in section 4.2.4, we consider an approach to increase PAYG and RCV run-off is appropriate given the company's low RCV run-off rates compared to the sector average and to target more closely the notional financial ratios included in the company's plan. In doing so we first make a PAYG adjustment to target the company's proposed level of adjusted interest cover in its business plan. We then advance revenue with the use of RCV run-off adjustments to target the funds from operations / net debt in the company's plan. The financial ratios stated in table 5.2 include the effect of the increase to PAYG and RCV run-off rates.

South East Water sets out in its representations that certain rating agencies reverse adjustments to accelerate revenues when calculating adjusted interest cover however, the company includes PAYG revenue advancement in its plan and its representation. As set out in the PR19 methodology, we consider revenue

[12] 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.

advancement is preferable to cost of equity adjustments as it is net present value neutral for customers over time and has the effect of crystallising some of the inflationary return related to the partial transition from RPI to CPIH as the measure of inflation. We discuss these issues further in the 'Aligning risk and return technical appendix'. Following our adjustments to PAYG and RCV run-off rates, the financial ratios for the notional company structure are broadly consistent with the ratios set out by South East Water in its business plan following the revenue advancement set out above.

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 the 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 South East 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	60.02%	59.74%	59.62%
Interest cover	3.92	3.93	4.19
Adjusted cash interest cover ratio (ACICR)	2.26	2.22	1.53
Funds from operations (FFO)/Net debt	9.86%	9.64%	9.86%
Dividend cover	2.26	1.38	1.67
Retained cash flow (RCF)/Net debt	8.06%	7.54%	7.81%
Return on capital employed (RoCE)	4.63%	4.23%	4.41%

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.

In presenting the ratios for our final determinations we exclude the effect of differing accounting treatment of infrastructure renewal expenditure from the numerator of the adjusted interest cover ratio to improve comparability of the financial ratios between companies. If calculated on a consistent basis with the final determination, South East Water's draft determination adjusted interest cover would be 1.70x.

South East Water also sets out in its representations that the Ofwat financial model overstate the adjusted interest cover financial ratio due to the treatment of pension deficit recovery payments. We correct the treatment of pension deficit in the financial ratios for the final determination which lowers the financial ratios compared to our draft determinations. We discuss these issues further in the 'Aligning risk and return technical appendix'.

We set out the average PAYG and RCV run-off rates along with the RCV growth over 2020 to 2025 for South East Water in table 5.3. RCV growth for the final determination is lower than in the company's April plan and in the draft determination. Overall, changes to allowed expenditure, the revised approach to determining the mix of operating and capital expenditure, the uplift to RCV run-off rates and the change to the PAYG rates means less expenditure is added to RCV.

Table 5.3: PAYG rates, RCV run-off and growth

	PAYG	RCV run-off	RCV growth
Company (April 2019)	60.8%	3.33%	11.31%
Draft determinations	62.2%	3.32%	7.67%
Final determinations	67.7%	3.67%	3.06%
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 'South East 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 £72 million above an adjusted cash interest cover of 1.0 times, providing headroom to our totex downside of £33 million and outcome delivery incentives downside of £27 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.

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

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

South East Water is a highly geared company. It reported gearing of 78.5% at 31 March 2019 and has committed to reduce gearing to around 75% by the end of 2020-25. The company has already taken steps to introduce £54 million of new equity since March 2019 but may need to take further action, including restricting dividends, to achieve its target gearing level.

At the time of our final determination South East Water has a credit rating of Baa2 (stable) with Moody's and BBB (stable) with S&P.

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 may need to take further steps to improve its financial resilience.

As set out in section 7, the company has proposed a base dividend for 2020-25 that is consistent with its intention to reduce gearing. 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. South East Water has committed to assess it 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 South East 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

South East Water proposes an average bill profile with a 0.6% reduction. Our bill profile contains a significantly greater reduction of 7.2% over 2020-25. South East Water does not submit any 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. South East 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 (that is, 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.

Due to deteriorating financial ratios at the end of the period, unlike for some other companies we have not been able to model a completely flat nominal bill for South East Water. The company still has a gradual real terms bill reduction over the period but South East Water's average bills will go up by a modest amount year-on-year

when inflation is added. We note that this increase will be below that which would have occurred under the company's draft determination bill profile.

Table 6.1: Bills in real terms (2017-18 CPIH deflated)

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company (April 2019)	£205	£204	£204	£204	£204	£204
Draft determinations	£205	£185	£185	£185	£185	£185
Final determinations – before reprofiling	£205	£194	£195	£195	£194	£193
Final determinations	£205	£198	£196	£194	£192	£190

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 including South East Water 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 South East Water will deliver a real terms reduction of 7.2% on the average bill between 2020 and 2025.

In addition, South East Water commits to:

- increase the number of customers that receive financial support from 40,000 at the end of the current regulatory period to 83,000 by 2024-25;
- increase its cross-subsidy to £5.50 to deliver its ambition on social tariffs;
- introduce new 'passport' scheme to allow third parties to accept customers directly onto their affordability schemes;
- create a vulnerability mapping tool that will combine external vulnerability risk factor data with priority services register data to improve customer outcomes; and
- report on its performance in relation to its vulnerability strategy annually through its website, and refresh the entire strategy every two years.

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

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

Companies will be reporting their performance against the Priority Services Register (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	18.9	19.6	20.2	20.7	21.0	100.3
Water network plus	200.4	199.8	199.1	198.3	197.9	995.4
Residential retail	18.0	17.9	17.7	17.5	17.3	88.5
Total	**237.3**	**237.2**	**236.9**	**236.5**	**236.2**	**1,184.2**

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 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	18.9	0.00%	3.37%	3.25%	2.65%	1.60%
Water network plus	200.4	0.00%	-0.29%	-0.27%	-0.36%	-0.23%

7 Putting the sector in balance

Key points

- South East Water reported gearing of 78.5% as at 31 March 2019. South East Water forecasts that its level of gearing (76.7% by 2021 and 76.0% by 2025) will trigger sharing of financing gains with customers on account of high gearing 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, South East Water is in line with 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[13];
- companies with high levels of gearing share financing gains from high gearing with customers; and

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

- 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 South East Water's proposals is in table 7.1. We comment on the financial resilience of South East Water in section 5.2.

Table 7.1: Our assessment of South East 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. The company forecasts that its gearing level will trigger sharing of financing gains with customers during 2020-25.
Voluntary sharing mechanisms South East Water does not propose any voluntary sharing mechanism. However, the company does propose company contributions to a hardship fund for customers who may be experiencing short-term or medium-term financial hardship and affordability issues caused through circumstances such as bereavement, job loss or sickness.
Dividend policy for 2020-25 South East Water 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 in a number of areas. Its representations indicated a base dividend yield of 1.77% over 2020-25 in line with its commitment to reduce gearing. The company's dividend policy refers to all 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 when setting dividend payments, it will take into account its performance against pre-set stretching outcome delivery incentive targets and its performance outside of the outcome delivery incentive framework, including other performance commitments made to customers but provides insufficient detail on the specific obligations and commitments to customers that will be considered. It also confirms that the level of performance delivery considered will be determined with reference to the final determination. The revised base dividend yield is in our view reasonable for a company performing in line with its price determination but the company has not indicated that dividends may be either increased or lowered from the base depending on the actual performance of the company and provides insufficient detail on how performance delivery will impact on dividends paid. The company commits that its dividend policy will be published in its annual performance reports together with explanations on how it was applied and the factors considered by the Board in authorising the distributions declared in the company's annual reports. The reasons for changes to its dividend policy will also be reported in the company's annual performance report.

Our assessment of the company's proposals to balance the interests of customers
Consistent with the lower allowed cost of equity in our final determination, we have revised our calculation of the dividend 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 of up to 4% but 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 South East 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, • 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. Based on our calculations, South East Water's measures that are directly aligned to customer delivery are in line with good practice, however we consider that there is scope for it to improve this position. We expect South East Water's policy on performance related executive pay to demonstrate a substantial alignment to the delivery of service for customers throughout 2020-25.
South East Water says it strongly believes that the current executive pay arrangements (for 2015-20) reflects an appropriate balance between outcomes customers have told the company are important and financial performance, and that it intends to use a similar approach in the design of the 2020-25 arrangements.
The company has told us it has revised its policy from that submitted in the business plan and has indicated that at a high level it will now consist of the following principles:
• the award will be made based on performance in five business areas: 1) customer satisfaction, 2) operational performance, 3) delivery of responsible business commitments, 4) financial performance and 5) individual objectives.
• reflecting best practice at least 60% of the award in the scheme(s) will be linked to delivery for customers and the remainder linked to financial performance and personal objectives.
• the executive remuneration scheme following similar principles ensuring they are focused on short-term and long-term performance.
• the annual bonus being more explicit on setting targets and assigning reward in relation to responsible business commitments including broader stakeholder considerations including employee engagement, community impacts, environmental performance etc.
• the executive remuneration scheme having a portion of the award deferred in a manner similar to the existing long-term incentive plan in 2015-20.
• target metrics will be stretching and reference the final determination, and for each metric there will be a threshold (minimum), base and stretch level of performance. Threshold, base and stretch will be set relative to:
  • AMP6 level of performance
  • the final determination target, and
  • the P10 and P90 levels of performance
  • The threshold level will be defined to ensure that improvement from AMP6 performance is incentivised i.e., set at a level greater than the actual AMP6 performance
• the incentive scheme(s) will be finalised using some or all of the metrics from the following:
  • 'common' performance commitments as identified by Ofwat
  • 'customer facing' commitments as identified by Ofwat
  • metrics with financial rewards and penalties
  • metrics that incentivise the management of the main outcome delivery incentive risks for AMP7
• the remuneration committee having the responsibility for designing, monitoring and reporting executive pay in accordance with its terms of reference.

Our assessment of the company's proposals to balance the interests of customers
• a commitment to report the details of the performance related pay schemes, including the awards made, transparently in the annual report. The company states that it will finalise and approve the final incentive scheme(s) following the final determination. 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 South East 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.

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December 2019

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