December 2019

PR19 final determinations

PR19 final determinations: South West 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 West Water' and sets out further details about the final determination price control, service and incentive package for South West 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 West Water to deliver;
- the allowed revenue that South West 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 four 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 West 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 West 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 detertmination.

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

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Amendment	**Date**
Page 6 - Amendment to text, replacing reference to Thames Water with South West Water to read: “Our final determination package includes a full set of performance commitments, specifying the minimum level of service that South West Water must commit to”. Page 17,Table 2.1 row 1 Amendment made to remove reference to symmetrical payment rates for water supply interruptions by deleting the last two sentences in the first row: “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~~." Page 17,Table 2.1 row 4 Fourth row – amendment made to underperformance payment rates for Knapp Mill and Alderney. Page 38, Table 3.7 – Amendment made to figures. • Grants and contributions before the deduction of income offset (£m) Network plus – Water amended from £59.8 million to £58.1 million, for Network plus – Wastewater amended from £52.5 million to £47.8 million. • Net allowed totex subject to cost sharing reconciliation Network plus – Water amended from £693.5 million to £695.2 million, for Network plus – Wastewater amended from £749.7 million to £754.4 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 a particular focus on improved service, affordability, increased resilience and greater innovation. South West Water was awarded fast track status at the initial assessment of plans on 31 January 2019. We expect fast track companies to demonstrate leadership on delivering positive outcomes for customers and the environment. South West Water has benefitted from its plan receiving fast track status. The company has been able to start implementing its plan ahead of 2020-25. The company also receives a financial reward, which is worth £6.7 million, in recognition that the company produced a high quality plan which included ambitious, innovation and sector-leading proposals, such as in relation to its outcome performance commitment and incentives package.

As South West Water is a fast track company we published our draft determination early on 11 April 2019. Our draft determination for South West Water was based on our detailed review of the business plan submitted to us on 3 September 2018 and the company agreeing to our initial assessment of plans interventions on 11 February 2019. South West Water confirmed that it opted into the early certainty principle entirely. This provides procedural benefits for specified components relating to outcomes and the cost allowance.

The company and other stakeholders made representations on our fast track draft determination by 24 May 2019. The company also made representations on our slow track and significant scrutiny draft determinations by 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 West Water, covering the customer bill profile, costs, outcomes for customers and allowed revenues. More detail is provided in the following sections of this document.

Bill profile

Our final determination for South West Water will cut average bills by 20.0% in real terms in the 2020-25 period compared to the company's proposed 13.9% reduction. This excludes the impact on bills of the current Government contribution to customers in the South West region. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in September 2018, our draft determination and the final determination. Average bills are lower than proposed by South West 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 (September 2018)	£527	£489	£483	£472	£464	£454
Draft determination	£527	£489	£478	£468	£458	£450
Final determination	£527	£458	£449	£439	£430	£422

Costs

Our final determination allows wholesale totex of £1,882.3 million. This is:

- £9.6 million lower than in our April 2019 draft determination and
- £58.8 million lower than the company's August 2019 representation on our draft determination.

Our final determination allows South West Water £312 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £145 million to improve the environment by efficiently delivering its wastewater obligations as set out in the Water Industry National Environment Programme;
- £68 million to address the impact of deteriorating raw water quality; and
- £42 million to improve resilience of water and wastewater networks.

We make an additional allowance of £3.9 million in our final determination for strategic water resource development to support the delivery of long-term drought resilience.

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

Outcomes for customers

Our final determination package includes a full set of performance commitments, specifying the minimum level of service that South West Water[3] 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 West Water

Area	Measure
Key common performance commitments	• 15% leakage reduction on a three year average basis. This is at least 15% reduction from PR14 performance commitment levels • 6% reduction in per capita consumption by 2024-25 • 58% reduction in pollution incidents by 2024-25 to 19.5 incidents per 10,000 km of sewers • 24% reduction in internal sewer flooding incidents by 2024-25 to 1.34 incidents per 10,000 sewer connections • 35% reduction in water supply interruptions by 2024-25 to 5 minutes
Bespoke performance commitments	• Biodiversity – Enhancement: 50,000 hectare increase over AMP7 (79%) • Achieve a four star rating on the Environmental Performance Assessment (EPA) carried out by the Environment Agency in 2023-24 and 2024-25 • 38% reduction in external sewer flooding incidents by 2024-25 • 17% reduction in sewer blockages by 2024-25 • 75% customer satisfaction for value for money by 2024-25 • 100% of details of customer on the priority services register checked every 2 years by 2024-25

[3] Amendment to replace 'Thames Water' with 'South West Water'.

	• 50,000 customers on social tariffs by 2024-25 • 100% of customers find bills affordable 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 – 2.12% (P10) to +1.84% (P90).

Note The calculations behind these numbers are outlined in the South West 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.

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

	Water Resources	Network plus- - water	Network plus - wastewater	Bioresources	Wholesale total	Residential retail	Total
Company view of allowed revenue (£m)	100.0	1,075.7	1,225.8	123.1	2,524.6	156.4	**2,681.0**
Final allowed revenues (£m)	94.8	1,052.9	1,120.9	117.7	2,386.3	137.7	**2,524.0**

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

The draft determinations for fast track companies, published in April 2019, included the 'early view' allowed return on capital, rather than the lower return allowed for slow track draft determinations published in July 2019. As set out in the 'Allowed return on capital technical appendix', we are updating our assessment of the allowed return on capital for South West 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 0.38 percentage points from our fast track 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 West Water's Regulatory Capital Value (RCV) growth in 2020-25 is 0.4% and 60% of its RCV will be indexed to CPIH in 2025.

We consider that South West Water's final determination is financeable on the basis of the notional structure, based on a reasonable allowed return on capital. 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 West 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 West Water expects to maintain gearing below the level that would trigger sharing payments under the gearing outperformance sharing mechanism in 2020-25.

To meet our expectations, the company will need to demonstrate to stakeholders that dividends and performance related executive pay policies are substantially aligned to its performance for customers. We expect the company will need to revise its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'.

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 West Water proposes a mechanism to share the outperformance of cost of embedded debt with customers. South West Water has estimated that this sharing is worth £20 million over 2020-25.

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 fast track draft determinations by 24 May 2019 and on our slow track and significant scrutiny 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 West Water in its representation, together with any further submissions after that date, and a summary of our response to each of those points.

Table 1.4: Company representation

Key point in South West Water representation (August 2019)	Summary of our response
South West Water argues that Ofwat has adjusted its totex allowance downwards by £125 million since it accepted fast track status. South West Water points to a reduction of £67 million at the initial assessment of business plans, a further £38 million implied by the slow track draft determinations in July 2019 and then £20 million for new connections.	South West Water accepted the £67 million reduction in totex when it accepted fast-track status in February 2019. We allow South West Water £9.6 million less wholesale totex than our April 2019 draft determination. We correct a £20 million error made by the company relating to new connections that were also included as third party services in its September 2018 business plan, otherwise South West Water would have received an increase in its totex allowance at final determination.
South West Water seeks a £93 million increase in totex allowance. This relates to Knapp Mill and Alderney treatment works, resilience improvements, leakage and wastewater enhancement. The company makes cost adjustment claims for UV treatment and growth, which it argues are not reflected in the Ofwat models.	We allow additional allowance for Knapp Mill and Alderney water treatment works. We make partial allowances for metering cost, raw water deterioration, replacing mains and expenditure for strategic regional resource solutions. We do not allow the cost adjustment claims for UV treatment, growth, leakage and resilience improvements (but do allow the costs for proposals to protect assets from flooding). See section 3.
South West Water requests £6.9 million additional funding for the Isles of Scilly and states that it reserves the right to reconsider its decision to provide services to the Isles of Scilly if the costs are not considered differently. It argues that uncertainty around the costs should be included in its WaterShare+ mechanism.	We allow the additional funding but do not include uncertainty around Isles of Scilly costs in WaterShare+ mechanism. The company opted into the early certainty principle in full, which covered cost claims such as the Isles of Scilly. In the PR19 methodology, we retain flexibility to alter our decision, e.g. if a company submits new information about actions required to meet legal obligations. We allow this based on the information South West Water provides.
South West Water argues that the allowed return set out in the slow track and significant scrutiny draft determinations is set too low. South West Water argues that the allowed return proposed in July 2019 would weaken its financial ratios and reduce its headroom. South West Water argues for an allowed return 59 basis points higher based on a number of methodological changes, including total market return, the risk-free rate, the asset beta, the ratio of embedded to new debt and the cost of embedded debt and the cost of new debt. South West Water states it does not see the justification for a further reduction in the allowed return.	We have carefully considered all of our duties, in particular our financing functions and consumer protection duties, and are satisfied that our final determination fulfils our duties in the round. Our assessment of notional financeability for the final determination is made in the context of changes made to the draft determination in our final determination. We consider the company's final determination is financeable on the basis of the notional structure based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure the company will be in a position to deliver its obligations and commitments to customers. It is the company's responsibility to maintain financial resilience under its actual financial structure and it

	must bear the risks associated with its choice of capital and financing structure. We use an allowed return on capital based on updated market evidence, as set out in our 'Allowed return on capital technical appendix'.
South West Water argues that Ofwat should continue to apply the PR14 service incentive mechanism methodology used for 2010-15 period to calculate service incentive mechanism performance payments for 2015-20. The company argues that, while it has improved service incentive mechanism performance year-on-year during 2015-20, it must make underperformance payments.	We consider that our approach for draft determinations remains appropriate for the final determination. It is consistent with our PR19 final methodology and reflects the outcome of our consultation on calculating service incentive mechanism and the quality of customer service provided by companies. We consider that our PR19 approach is more appropriate than rolling forward the PR14 approach, as it requires less regulatory judgement and it uses the full incentive range, which we consider is appropriate given the spread of performance across the sector.
South West Water seeks changes to a small number of performance commitments. It wants changes to the internal sewer flooding enhanced outperformance rates. It requests that the new compliance risk index (compliance risk index) deadband applies to the company and requests that Ofwat does not increase the financial incentive on D-MeX because it is a new mechanism and full confidence will be gained after the shadow year.	We retain the internal sewer flooding enhanced outperformance rates at the same rates as we proposed at fast track draft determination because we do not find the company's criticisms of our approach to be convincing. The company has early certainty on outcome delivery incentive rates. We apply the revised sector compliance risk index deadband of 2.00 despite the company opting for early certainty on this performance commitment. This is appropriate given the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court. We retain the D-MeX incentive rates because those rates deliver customer benefit and Government priorities. We have trialled this measure for 18 months during the pilot year (18/19) and 6 months of the shadow year (19/20).

We also received representations on South West 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 (CCWater) (May 2019) broadly supports the draft determination in its May 2019 representation. CCWater asks that the £50 government contribution in the South West region is explained in the final determination and seeks assurance that the company has adequately engaged with customers about the cost related to the Isles of Scilly.	We can confirm that the bill numbers included in this final determination do not include the £50 government contribution in the South West region. We are providing South West Water with the cost allowance that the company sought in relation to the Isles of Scilly. It is for South West Water to engage with customers on the costs of the Isles of Scilly, including any impact on customer bills.
The Environment Agency broadly supports the fast track draft determination and the performance commitment for the company to achieve a four star EPA rating. It questioned whether the pollution incident underperformance incentive delivery rate is too small.	We do not change the underperformance incentive rate for pollution incidents. We consider that the underperformance payment rate provides sufficient incentive for South West Water to improve performance. The rate for this performance commitment is also covered by the early certainty principle.
South West Business Council supported South West Water's representation on the fast track determination.	We note the South West Business Council's support for South West Water's business plan.
Invesco, an investor in Pennon (the parent company of South West Water), has concerns that the proposed cost of equity is low, and any further reductions would be hard to justify, and our use of the Capital Asset Pricing Model (CAPM). It suggests investor risk in the water sector is increasing given public scrutiny, nationalisation risks and the downward trajectory for allowed returns.	Our allowed return on capital is estimated using the well-established approach of using the CAPM, and is aligned with City analyst expectations. Our nominal allowed return on equity (6.3%) is only slightly below the median return for FTSE 100 companies over the past three years (7.6%). This lower return is unsurprising for a sector characterised by low demand risk, inflation protection and predictable and stable revenues.

1.3 Key changes from the draft determination

Our final determination carefully considers the representations we received from companies and stakeholders on our fast track draft determinations on 24 May 2019 and on our slow track and significant scrutiny 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)	2,660.2	2,524.0
Wholesale cost allowance[1] (£m, 2017-18 CPIH deflated)	1,891.9	1,882.3
Retail cost allowance (£m, nominal)	140.4	141.0
Wholesale allowed return[2] (% - CPIH basis)	3.30%	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 West Water are:

- We allow an additional £6.9 million of costs for the Isles of Scilly and additional costs for Knapp Mill and Alderney water treatment works. We expand our definition of base costs to include costs that are driven primarily by population growth.
- 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.
- 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 to a score of 2.00 for 2020-25, reducing the risk of underperformance payments in the last three years.
- We expect the company will need to reduce its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield.

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. We make changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction levels for mains repairs.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company
- We amend the deadband on the Compliance Risk Index (which measures compliance with the Drinking Water Inspectorate's (DWI) 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. 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.

Throughout PR19, we have been asking companies to:

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

The outcomes framework is a key component in driving companies to focus on delivering the objectives that matter to today's customers, future customers and the environment in the 2020-25 period and beyond. Outcomes define the service package that companies should deliver for their customers and their incentives to do this.

There are two key elements of the outcomes framework: performance commitments and outcome delivery incentives. Performance commitments specify the services that customers should receive and set out in detail the levels of performance that the companies commit to achieve within the five year period from April 2020 to March 2025. Outcome delivery incentives are the reputational and financial incentives that companies have, to deliver on their performance commitments to customers. They specify the financial or reputational consequences for companies of outperformance

or underperformance against each of these commitments (they are referred to as 'out' where there is a payment to the company for better than committed performance, 'under' where there is a payment to customers where there is worse than committed performance, or 'out-and-under' incentives, depending on their design).

Most outcome delivery incentives will be settled at the end of each year to bring incentive payments closer to the time of delivery of the service ('in-period' incentives) and some will be settled once at the end of the five year period ('end-of period' incentives). The outcomes framework gives companies the freedom to innovate and explore to find the most cost-effective way of delivering what matters to their customers.

South West Water is improving performance during PR14 generally with the exception of water quality contacts and pollution incidents where performance in 2018-19 deteriorated. It is now one of the best performing companies on the service incentive mechanism after continuous year-on-year improvement. The company achieved net outperformance payments in 2018-19.

In its September 2018 business plan, the company proposed a balanced package of performance commitments that overall reflects customer views, including outcome delivery incentives that are appropriately based on customer valuations. However, whilst the company proposed stretching levels on some performance commitments, for example internal sewer flooding and pollution incidents, it did not propose stretching levels for all performance commitments. In addition, we considered that its customer protection policy, to protect customers from excessive outperformance payments, was not detailed enough.

To achieve fast-track status, South West Water agreed to a series of actions on its performance commitments and incentives, which we included in its fast track draft determination. These increased the stretch on some key performance commitment levels including water supply interruptions and bathing water quality. They also reduced some potential outperformance payments (including for leakage and internal sewer flooding) and increased some potential underperformance payments (including compliance risk index, pollution incidents and mains repairs). We also made some additional changes in its fast track draft determination including reducing the enhanced outcome delivery incentive outperformance rate for internal sewer flooding to two times the standard rate.

In its representations, the company focuses on three main issues: the compliance risk index deadband, internal sewer flooding enhanced incentive rate and incentives on D-MeX[4].

[4] Further information on this can be found in the 'Customer measure of experience (C-MeX) and developer services measure of experience (D-MeX) policy appendix'.

On compliance risk index, the company proposes that the industry wide deadbands apply to it despite early certainty applying to deadbands. For all companies, we amend the deadband on the compliance risk index to a score of 2.00 throughout the period. We accept the company's proposal for an increase in the level of the company's deadbands as an exception to its early certainty position, due to secondary legislation not being implemented as expected.

At fast track draft determinations, we intervened to reduce the company's enhanced outperformance rate for internal sewer flooding, when we reduced the company's standard rate. The company disagreed with our approach and cited customer support for its previous rate, however, we consider it remains justified see section 2.1 below.

As noted above, the company considers that we should not increase financial incentives on D-MeX. We retain the D-MeX incentive rates because those rates deliver customer benefit and we consider align with Government priorities set out in the UK Government's Strategic Policy Statements. We have trialled this measure for 18 months during the pilot year (2018-19) and 6 months of the shadow year (2019-20). This is considered in more detail in the 'Customer measure of experience (C-Mex) and developer services measure of experience (D-Mex) policy appendix'.

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 West Water demonstrated elements of high-quality customer engagement evidence. Namely, the company provides sufficient evidence to justify outcome delivery incentive that it proposes, and it set out clear principles to inform the setting of these incentive types. In most cases where it proposed outperformance payments, it clearly highlighted customer evidence to support its position.

In its representations to our fast track draft determinations, South West Water states that our intervention on its enhanced outperformance rate for internal sewer flooding is not consistent with its evidence of customers' views. It argues that this performance commitment is a key priority for their customers and was valued highly in their willingness to pay research. The company's September business plan stated that its customers indicated the level of an enhanced rate should be approximately double the standard rate. The company's enhanced rate proposed in its September business plan was set on the basis of this research as double the standard outperformance rate. Therefore it is appropriate that the company proportionally reduce its enhanced outperformance rate in line with the reduction in its standard outperformance rate and we consider our adjustment was justified. The company has early certainty on outcomes delivery incentive rates and we retain the fast track draft determination rates. The company's customer challenge group did not submit any representations in response to our fast track 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 West 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 West 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 West 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.

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.[6]
We are amending 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.
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 at 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.
Accepting the company's proposals to update the delivery dates of its planned build of two new treatment works and therefore the performance commitment levels, for each scheme because the revised profile has been discussed and agreed with the Drinking Water Inspectorate. The updated cost allowance requires an adjustment to the underperformance payment rates to £0.519m[7] (Knapp Mill) and £0.590m (Alderney)
Increasing the performance commitment levels in relation to risk of sewer flooding in a storm. We consider that the company's model coverage of its network is low relative to the rest of the industry and which we consider is likely to mean the company has a poor understanding of the risks of sewer flooding in its region.

[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.
[6] Correction made to remove reference to symmetrical payment rates for water supply interruptions.
[7] Correction made to underperformance payment rates for Knapp Mill and Alderney.

Key changes
Accepting the company's underperformance rate on leakage to reflect an amendment of a transposition error in our ‘South West Water – Outcomes performance commitment appendix issued in April 2019’.

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	End of period	
Water quality compliance (CRI) [PR19SWB_PC A1]	X		X		
Water supply interruptions [PR19SWB_PC A2]	X	X	X		
Leakage [PR19SWB_PC C2]	X	X	X		
Per capita consumption [PR19SWB_PC C3]	X	X		X	
Mains repairs [PR19SWB_PC A3]	X	X	X		
Unplanned outage [PR19SWB_PC A4]	X		X		
Risk of severe restrictions in a drought [PR19SWB_PC D1]					X
Priority services for customers in vulnerable circumstances [PR19SWB_PC E6]					X
Internal sewer flooding [PR19SWB_PC B1]	X	X	X		
Pollution incidents [PR19SWB_PC F1]	X		X		
Risk of sewer flooding in a storm [PR19SWB_PC D2]					X
Sewer collapses [PR19SWB_PC B3]	X	X	X		
Treatment works compliance [PR19SWB_PC B6]	X		X		
C-MeX: Customer measure of experience [PR19SWB_PC E1]	X	X	X		
D-MeX: Developer services measure of experience [PR19SWB_PC E4]	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	
Taste, smell and colour contacts [PR19SWB_PC A5]	X	X	X		
Water restrictions placed on customers [PR19SWB_PC C1]	X			X	
External sewer flooding incidents [PR19SWB_PC B2]	X	X	X		
Sewer blockages [PR19SWB_PC B4]	X	X	X		
Odour contacts from wastewater treatment works [PR19SWB_PC B5]	X	X	X		
Descriptive compliance [PR19SWB_PC B7]	X		X		
Total wastewater treatment works (WWTW) compliance [PR19SWB_PC B8]					X
Compliance with sludge standard [PR19SWB_PC B9]	X		X		
Resilience in the round - wastewater [PR19SWB_PC D3]	X	X	X		
Resilience in the round - water [PR19SWB_PC D4]	X	X	X		
Operational contacts resolved first time - water [PR19SWB_PC E2]	X	X	X		
Operational contacts resolved first time - wastewater [PR19SWB_PC E3]	X	X	X		
Customer satisfaction with value for money [PR19SWB_PC E5]					X
British Standard for inclusive service provision [PR19SWB_PC E7]					X
Overall satisfaction of services received on the PSR [PR19SWB_PC E8]					X
Number of pollution incidents cat 1-3 (water only) [PR19SWB_PC F2]	X		X		
Biodiversity - Compliance [PR19SWB_PC F3]					X
Biodiversity - Prevent Deterioration [PR19SWB_PC F4]					X
Biodiversity - Enhancement [PR19SWB_PC F5]	X	X		X	
EPA [PR19SWB_PC F6]	X		X		
Bathing water quality [PR19SWB_PC H1]	X	X		X	
Abstraction incentive mechanism [PR19SWB_PC H2]	X	X	X		

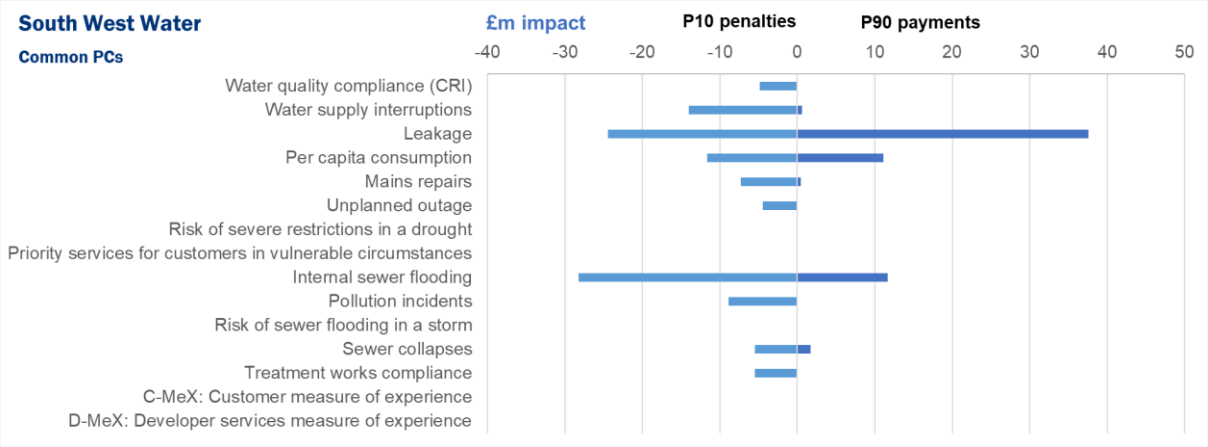
Name of bespoke performance commitment	Type of outcome delivery incentive				
	Financial				Reputational
	Under	Out	In-period	End of period	
Installation of AMR meters [PR19SWB_PC G1]					X
Number of customers on one of our support tariffs [PR19SWB_PC G2]					X
Voids for residential retail [PR19SWB_PC G3]					X
Percentage of customers who find their water bill affordable [PR19SWB_PC G4]					X
Efficient delivery of the new Knapp Mill WTW [PR19SWB_PCA6]	X			X	
Efficient delivery of the new Alderney WTW [PR19SWB_PCA7]	X			X	
Resilient water and wastewater services on the Isles of Scilly [PR19SWB_PCD5]	X		X		

Figure 2.1 and figure 2.2 provide an indication of the financial value of each of South West 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 February 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 West Water	-3.2	1.6	-2.12	1.84

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

We are applying caps and collars to financially material and/or highly uncertain performance commitments and allowing caps and collars on other performance commitments where company proposals are supported by high quality customer engagement. Where, through these reasons, the vast majority of companies have caps and collars on a common performance commitment, we will apply caps and collars to all companies.

We are applying a standard sharing mechanism for all companies, where 50% of outperformance payments that exceed 3% of return on regulatory equity (RoRE) in any year are shared with customers through bill reductions in the following year. We set out further detail of the mechanism in the 'Delivering outcomes for customers policy appendix'.

In our PR19 methodology, we decided to replace the existing Service Incentive Mechanism (SIM) with two new common performance commitments to incentivise companies to provide an excellent experience for residential customers (our customer measure of experience, or C-MeX) and developer services customers (our developer services measure of experience, or D-MeX). C-MeX and D-MeX will operate from April 2020 and incentivise companies to improve their performance relative to other water companies and the wider economy.

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

2.3 Delivering a framework for resilience in the round

Resilience is one of our four themes for PR19. We set out our expectations for water companies' business plans in our PR19 final methodology[8]. Overall, South West Water's September 2018 business plan provides high quality evidence in most aspects of securing long-term resilience, although it falls short of being ambitious and innovative. The company's business plan provides evidence that the company considers a wide range of both internal and external risks that impact on operational and corporate resilience. It also provides evidence of high quality engagement with customers on long-term resilience, including risk profiles and service expectations. There is also evidence of a wide range of mitigations being implemented and co-created with stakeholders.

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 West Water an action (SWB.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, the South West Water's resilience action plan falls short of our expectations in many areas. In particular, we are concerned that:

- the company does not demonstrate how the maturity assessment has been used to identify specific priority actions for resilience improvements. We expect the company to clearly demonstrate how its action plan is influenced by an understanding of its baseline maturity;
- the company does not provide sufficient evidence on how the long list of resilience risks has been assessed and prioritised. We expect the company to evidence the approach it had taken to identify its priority risks; and
- the company's action plan lacks the details on resource requirements and accountability for delivery of specific actions to give us confidence that a robust plan is in place for the company to deliver an integrated resilience framework. We expect the resilience action plan to provide sufficient detail to demonstrate a robust path to implementing the company's action plan, including clear governance and accountable owners for actions.

Overall, South West 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

[8] The 2015 resilience task and finish group report, 'Resilience in the round' document and PR19 final methodology together set out the guiding principles with respect to long term resilience.

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 cost allowance for South West Water is £1,882.3 million for the wholesale services. This compares with £1,891.9 million at draft determination. In retail, our final determination allowance is £141.0 million, compared with £140.4 million at draft determination.
- Our base allowance is affected by a number of changes we have made since South West Water's draft determination:
  - we expand our definition of base costs to include costs that are driven primarily by population growth;
  - we move from a capex to a totex assessment of enhancement activities;
  - we change our approach to forecasting several of the explanatory factors in our econometric models;
  - we include company outturn data from 2018-19 in our econometric models;
  - we exclude non-section 185 diversions costs (i.e. diversions other than those required by section 185 of the Water Industry Act 1991) from our econometric models and allow companies to recover related income outside the price control, from the relevant transport authority;
  - we strengthen the catch-up challenge applied to wholesale modelled base costs. We use the fourth placed company in wholesale water and the third placed company in wholesale wastewater as an efficiency benchmark, rather than the 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.
- South West Water makes further representations in response to draft determinations for slow-track companies. We accept those relating to the Isles of Scilly and make a full allowance, whilst partially accepting investments for metering and raw water deterioration, to replace mains and expenditure for strategic regional resource solutions. We reject all other claims.
- We correct a £20 million error made by the company relating to new connections that were also included as third party services in its September 2018 business plan, otherwise South West Water would have received an increase in its totex allowance at final determination compared with its draft determination.

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 West Water submits a business plan for 2020-25 that is broadly efficient in wholesale water, but about 6% inefficient in wastewater and over 10% inefficient in residential retail compared with our view of efficient costs. We challenge South West Water's proposed costs to ensure customers pay only for efficient costs. Our allowance for South West Water is slightly higher than at draft determination.

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 West Water – Cost efficiency final determination appendix' we provide more detailed information on our cost challenge for enhancement expenditure, our allowance for cost adjustment claims and transitional expenditure and our unit cost adjustments related to uncertain schemes in Wastewater environmental obligations (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	15.7	16.3	15.3	14.3	13.8	75.3	80.3
Water network plus	160.1	173.6	184.7	177.0	172.3	867.8	859.8
Wastewater network plus	185.0	182.0	163.5	162.5	151.6	844.6	898.2
Bioresources[2]	19.1	19.4	18.8	18.7	18.5	94.5	102.7
Total	**379.9**	**391.3**	**382.3**	**372.6**	**356.2**	**1,882.3**	**1,941.1**

[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.
[2] The bioresources control is an average revenue control. The totex allowance in our draft determination is based on a forecast level of tonnes of dry solids.

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.

For final determinations, we expand the scope of costs included in base expenditure beyond that of the fast track draft determination. Our base costs include operating and maintenance costs. In addition, our base costs for wholesale water include costs associated with the connection of new developments (i.e. new developments and new connection costs) and costs for addressing low pressure. Our base costs for wholesale wastewater include new connections and growth, growth at sewage treatment works and costs to reduce flooding to properties that were previously assessed as enhancement expenditure.

We adjust allowed costs to reflect a change in the accounting treatment of leases as discussed in section 8.4 of 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	Wastewater network plus	Bioresources	Total
Base expenditure	64.6	709.3	676.6	90.5	1,541.1
Enhancement expenditure	9.4	144.9	155.4	2.3	312.0
Operating lease adjustment	0.0	-3.3	-3.3	0.0	-6.6
Gross allowed totex for calculation of cost sharing rates	**74.0**	**850.9**	**828.7**	**92.9**	**1,846.4**
Strategic regional water resources solutions and other cash items	1.0	2.9	-	-	3.9
Third party costs	-	4.7	7.7	-	12.4
Non-section 185 diversions	-	0.5	0.0	-	0.5
Ex-ante cost sharing adjustment	-	-	-	-	-
Gross totex	**74.9**	**859.0**	**836.5**	**92.9**	**1,863.3**
Grants and contributions after adjustment for income offset[1]	0.1	45.4	48.2	-	93.7
Net totex used in PAYG calculation	**74.9**	**813.5**	**788.3**	**92.9**	**1,769.5**
Pensions deficit recovery costs[2]	0.4	8.9	8.1	1.6	19.0
Total	**75.3**	**822.4**	**796.4**	**94.5**	**1,788.6**

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

Movement in allowed wholesale expenditure between draft and final determinations

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

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

Table 3.3 also provides the company's requested costs in its September 2018 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 September 2018	Company August 2019	Draft determination allowance	Final determination allowance
Wholesale water	906.1	925.3	902.2	928.2
Wholesale wastewater	983.3	983.2	939.4	924.9
Total	**1,889.3**	**1,908.5**	**1,841.7**	**1,853.1**

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

	Draft determination allowance	Final determination allowance
Base expenditure	1,408.8	1,541.1
Growth	122.3	
Enhancement	310.6	312.0
- Environmental obligations (WINEP)	174.5	156.4
- Supply-demand balance and metering enhancement	10.7	12.5
- Resilience enhancement	11.0	42.4
- Other enhancement	114.4	100.7

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	65.3	64.6
Water Network plus	633.9	709.3
Wastewater Network plus	697.4	676.6
Bioresources	93.6	90.5
Total	**1,490.2**	**1,541.1**

Note Company business plan base costs exclude enhancement opex.

South West Water makes representations related to growth costs in water and wastewater; the cost of ultraviolet (UV) treatment in wastewater, and in relation to investments in the Isle of Scilly.

For final determinations we include growth related expenditure in our base econometric models. In response to draft determinations, South West Water submitted two claims for additional costs for growth related expenditure in water and wastewater, for a total of £29 million. The company does not provide sufficient and convincing evidence to justify the need for an adjustment to its growth allowance above the allowance it receives from our base econometric models, and since our base and growth allowance is higher than at the draft determination we do not make an adjustment.

South West Water argues that UV treatment has not been accounted for at a sufficiently aggregated level (unlike other treatment permits) within our base wastewater model. It makes a cost adjustment claim for £13.6 million. While the company provides evidence that their particular UV tertiary treatment costs are higher than other companies, our analysis shows that its overall tertiary treatment requirements (based on forecast total load requiring tertiary treatment for 2020-25) is not exceptional relative to the industry. We consider that our base allowance for wastewater is appropriate.

South West Water requests £41 million to provide water and wastewater services to the Isles of Scilly.[9] It expects to take responsibility over services to the Isles of Scilly during 2020-25. At draft determinations we allowed £34.4 million. Our main challenge was on the application of optimism bias. In representations made at slow track draft determinations, South West Water presents new information to support this claim and outlines the additional risk it identifies.

South West Water opted for early certainty as part of accepting our fast track proposals. This means that we do not typically change our decision on the company's cost adjustment claims. We said in the PR19 methodology that, to maintain the integrity of the regulatory framework, we would retain the flexibility to consider that it is appropriate to recognise the circumstances and revise our draft

[9] The claim pertains both to base and enhancement. We discuss it here as this is a single claim.

determination decision in exceptional circumstances such as when there is new information about the actions required to meet current legal obligations.

We accept that South West Water may not have had sufficient time to arrive at a fully considered position on these costs, due to the timing of when the company identified the additional risks. We acknowledge that significant uncertainty related to costs in this area remains despite South West Water's due diligence. For final determinations, we allow the requested costs in full.

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	14.2	9.4
Water Network plus	211.8	144.9
Wastewater Network plus	184.7	155.4
Bioresources	7.6	2.3
Total	**418.3**	**312.0**

Our final determination allows South West Water £312 million to invest in improvements to service, resilience and the environment.

Key parts of the final determination allowance are:

- £145 million to improve the environment by efficiently delivering its wastewater obligations as set out in the Environment Agency's Water Industry National Environment Programme;
- £68 million to address the impact of deteriorating raw water quality; and
- £42 million to improve resilience of water and wastewater networks.

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

Wastewater environmental obligations

Our comparative assessment of wastewater WINEP costs shows South West Water to be efficient as it is lower than our modelled allowance. We allow the full requested amount of £145 million.

Addressing deteriorating raw water quality

South West Water proposes investment at a total of seven water treatment works to address raw water deterioration. It provides representation on our slow track draft determinations and requests us to revise the cost challenges we made at its fast track draft determination.

South West Water allocates 50% of the Knapp Mill and Alderney cost adjustment claims to base with 20% raw water deterioration and the remaining 30% to the resilience enhancement line. The company provides sufficient evidence of long-term trends in the deterioration of raw water quality at both works and the optioneering completed for these schemes. We accept the claim but apply an efficiency challenge due to lack of sufficient and convincing evidence that the proposed costs are efficient.

For the schemes at five other water treatment works South West Water requests £40.2m capex. At draft determination we found insufficient detail to allow the full costs, we applied a cost challenge at programme level and made an allowance of £30.6m. The company provides further evidence in its representation to the slow track draft determinations, August 2019. On the basis of this evidence we continue to challenge option selection at Restormel, Littlehempston and Stithians and allow the costs for the presented least cost options the company considered at these locations. For the two other schemes we consider the additional evidence that the company provides to be sufficient. We now allow £34.4m for this programme. In its representation to the slow track draft determinations South West Water also identifies an opex cost gap for the five schemes. At its draft determination we did not make an additional allowance for operating the enhanced treatment works processes at these sites because we considered that such costs were included in our base modelling. For final determinations we use the companies' forecasts of treatment complexity as the cost driver in our models so we are confident our base allowance includes the operational costs of operating the additional treatment processes. We provide more information in the 'Securing cost efficiency technical appendix'.

South West Water also provides more evidence on the increase in extent of catchment management schemes to address raw water deterioration compared to the 2015-20 period. We accept the evidence and make an additional allowance subject to an efficiency challenge. We note that this programme includes the River

Stour metaldehyde project. Given the likely ban on the use of metaldehyde, we do not allow these costs as part of our of our totex allowance, but make provisions for the company to recover these costs, should the ban on metaldehyde not be applied, under an uncertainty mechanism. (see South West Water – Cost efficiency final determination appendix).

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, we make an enhancement allowance for leakage reduction. As this is not achieved by South West Water, our allowance is unchanged from draft determination and we do not allow any of the requested £11.3 million under enhancement. This requested amount includes costs relating to valve maintenance and pressure management presented in the 'Clean Water Service other' freeform line, as we consider this primarily relates to leakage reduction activities. In 'Securing cost efficiency technical appendix' we set out our policy on the funding of leakage reduction costs, including how we derive the upper quartile threshold for leakage enhancement costs.

Metering

South West Water provides further information in its representation that clearly identifies expenditure associated with replacement of basic meters with smart meters. Some of this investment forms part of the 'Clean Water Service Other' freeform line that we assess within a metering deep dive assessment. This is in addition to the expenditure associated with new smart meter installations which we reviewed at draft determination, allowing the £6.7 million request in full. At final determination, we review the evidence the company provides and assess the total requested expenditure of £11.7 million consistently with the approach taken for other companies, which we explain in the 'Securing cost efficiency technical appendix'. We find that South West Water's replacement costs are significantly higher on a per meter basis than those presented by other companies and therefore we make an allowance of £8.6 million based on the average cost we observe from other companies' proposals.

Treatment works improvements and service reservoirs

South West Water requests additional allowances of £4.0 million and £7.3 million for service reservoirs and water treatment works improvements respectively. We consider that these costs are growth-related and are captured in our base allowance. We do not make an enhancement allowance for these costs.

Resilience

For final determinations, South West Water provides additional evidence which aims to demonstrate that the activities associated with its Resilient Service Improvement investment (£10 million) are enhancement expenditure. However, we consider this investment relates to day-to-day control and management systems, which are base cost activities. We consider that our base allowance is sufficient to deliver these activities efficiently and do not make an enhancement allowance for these costs.

The company does not raise substantive issues on its wastewater resilience enhancement allowance, which allowed £3.7m of investment to improve the resilience of its wastewater treatment works.

Our final determination allowance for resilience enhancements across water and wastewater is £42.4 million.

Sludge quality and growth

South West Water continues to request £5.2 million to invest in sludge capacity and enabling projects to facilitate the bioresources market. The company argues that investment will help combat challenges posed for sludge management in its region which has small coastal population centres and large transport distances between its small wastewater treatment works and sludge treatment centres. We support the company's approach to enabling the bioresources market.

However, South West Water does not explicitly evidence the need to invest to accommodate growth in sludge production. Sludge growth can often be managed within existing capacity. Further, if the investment is aimed to increase savings by optimising the management of sludge treatment, then it is not clear that customers should pay for it upfront. We therefore do not make an allowance for the proposed expenditure.

Strategic water resource development

We make an additional allowance in our final determination for strategic water resource development to support the delivery of long-term drought resilience. We set out our policy on funding of these strategic solutions in the ‘Strategic regional water resource solutions appendix’. We made an allowance of £3.9 million available for South West Water to develop strategic regional water resource solutions in association with other companies. Based on representations through the West Country Water Resources group the two solutions that South West Water is funded to participate in will follow the standard gate timeline.

South West Water also requests £5.5 million of additional expenditure in its representation to potentially trade an extra 10Ml/d with Southern Water, which is

linked to one of the solutions identified as part of the strategic solution development programme. This expenditure would be to increase the maximum output capacity of the Knapp Mill water treatment works. We consider that allowing this expenditure at final determination would commit to a strategic regional solution that may not be selected as best value. The schedule of work on this project suggests that this decision can be made late in the 2020-25 period and therefore investment could be included at the next price review for 2025-30.

3.4 Cost sharing

In the water resources, water network plus and the wastewater 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.

Table 3.7 sets out the cost sharing rates for PR19 and net totex that is subject to these rates at the end of the 2020-25 period. On the basis that South West Water accepted our cost allowances in the round as part of the fast track draft determinations, we set the cost sharing rates at 50%.

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	Network plus - wastewater
Cost sharing rate for out and underperformance	50%		50%
Grants and contributions before the deduction of income offset (£m) [10]	0.1	58.1	47.8
Abstraction charges and business rates (£m)	31.4	97.6	26.5
Net allowed totex subject to cost sharing (£m) [11]	42.5	695.2	754.4

[10] Amendment to Grants and contributions before the deduction of income offset for Network plus – water and Network plus- wastewater

[11] Amendment to Net allowed totex subject to cost sharing for Network plus – water and Network plus – wastewater.

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.

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

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	28.0	28.2	28.2	28.3	28.3	141.0
Company view	32.8	32.2	31.9	31.5	31.3	159.8

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.

South West Water's business plan identified a potential strategic regional resource scheme that may be suitable for direct procurement for customers, the West Country-Southern Water transfer. We expect this scheme and any other major schemes which may arise due to significant changes to the South West 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 West 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 £2,524.0 million of revenue across all price controls for South West Water in the final determination, compared to £2,660.2 million in the draft determination and £2,681.0 million in the company's September 2018 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 0.38 percentage points from our fast track 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.
- As a fast track company, our determination includes a reward equivalent to a return of 10 basis points on regulatory equity.
- In line with the draft determinations for slow track and significant scrutiny companies, we make a technical intervention to PAYG rates to maintain South West Water's approach to setting PAYG rates and take account of our view of the mix of operating and capital expenditure. We revise our approach for final determinations to take better account of the nature of our interventions to cost allowances.
- Allowed revenue includes South West Water's contribution to the innovation competition.
- We revise our approach to calculating grants and contributions.
- We reflect South West Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission.
- Our final determination includes finalised scores for 2018-19 in the residential retail service incentive mechanism. This reduces revenue by £2.9 million compared to the zero values we included in the draft determination for the fast track companies.

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, water network plus, wastewater network plus and bioresources), 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.
- Fast track reward - fast-track companies are awarded a financial reward for achieving fast-track status. We retain the approach adopted at the draft determination to provide an award equivalent to 0.1% of return on regulatory equity. Companies are able to decide how they receive this reward either through an adjustment to revenue or to opening RCV.
- 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 here (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-s185 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 West 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	Wastewater network plus	Bioresources	Total – Final determination	Total - Draft determination
Pay as you go	59.1	487.0	417.6	71.9	1,035.5	1,083.4
RCV run-off	18.1	328.1	430.0	33.5	809.8	820.8
Allowed return on capital	16.5	169.0	202.5	9.3	397.3	464.3
Revenue adjustments for PR14 reconciliations	1.0	-13.9	-16.2	0.0	-29.1	-11.3
Fast track reward	0.0	1.8	2.2	0.0	4.1	2.4
Tax	0.2	33.8	36.7	2.9	73.6	93.7
Grants and contributions after adjustment for income offset (price control)	0.1	43.7	43.5	0.0	87.3	64.5
Deduct non-price control income	0.0	-1.2	-0.3	0.0	-1.5	-1.5
Innovation competition	0.0	4.2	4.6	0.0	8.8	0.0
Revenue re-profiling	0.0	0.2	0.2	0.0	0.5	1.6
Final allowed revenues	**94.8**	**1,052.9**	**1,120.9**	**117.7**	**2,386.3**	**2,518.0**

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'South West Water - Allowed revenue appendix' in tables 1.1 to 1.4.

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 West Water stretching outcome performance commitments and by setting the cost efficiency challenge according to the performance of the leading companies.

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[12], 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.

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

- Net margin on wholesale and retail activities – this is calculated based on the wholesale revenue applicable to residential retail customers, plus the retail cost to serve, with a net margin applied. Net margins are calculated excluding any adjustments to residential retail (see table 4.2 below) – the full calculation is set out in our financial models.
- Our methodology set out an early view of the retail margin that applies for the retail price controls. This was used by South West 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)	2,697.7	2,521.1
Proportion of wholesale revenue allocated to residential (%)	74.3%	74.3%
Residential retail costs (£m)	140.4	141.0
Total retail costs (£m)	**2,145.0**	**2,014.4**
Residential retail net margin (%)	1.0%	1.0%
Residential retail net margin (£m)	**21.6**	**20.3**
Residential retail adjustments (£m)[1]	-4.4	-9.0
Residential retail revenue (£m)[2]	**157.7**	**152.3**

[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 West Water - Allowed revenue appendix' in table 1.5.

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

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

To determine the allowed revenue, the PAYG rate is applied to the totex allowance for each wholesale control for each year of the price control. The proportion of the totex allowance that is not recovered in PAYG is added to the RCV and recovered from customers in future periods. For the final determinations we revise our approach to the calculation of PAYG rates to better reflect the source of changes we make to costs claimed by companies as a result of our totex cost assessment. Our revised approach follows a process of further consultation with companies following the submission of representations on the draft determination. We explain our revised approach in 'Securing cost efficiency technical appendix'.

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

4.2.1 PAYG in allowed revenue

We calculate total PAYG totex for each year of each wholesale price control based on the net 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 West Water - Allowed revenue appendix', tables 2.1 to 2.4.

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	Wastewater network plus	Bioresources	Total
Totex allowance (£m)	74.9	813.5	788.3	92.9	**1,769.5**
Final determination PAYG rate (%)	78.3%	58.8%	51.9%	75.7%	**57.4%**
Pay as you go totex (£m)	58.6	478.1	409.5	70.3	**1,016.5**
Pension deficit recovery cost (£m)	0.4	8.9	8.1	1.6	**19.0**
Total pay as you go (£m)	**59.1**	**487.0**	**417.6**	**71.9**	**1,035.5**

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

	Water resources	Water network plus	Wastewater network plus	Bioresources
Original company plan (%)	74.7%	57.4%	54.4%	71.9%
Draft determination (%)	81.6%	62.0%	52.3%	76.0%
Final determination (%)	78.3%	58.8%	51.9%	75.7%

In the draft determination, we applied South West Water's approach to PAYG rates of recovering in each year an amount equivalent to operating costs plus infrastructure renewal costs. South West Water does not make any representations in relation to our approach to PAYG rates and we apply the same approach for the final 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.

We are not adjusting PAYG rates as a result of our financeability assessment. We set out our financeability assessment in section 5.2.

The movement 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 totex allowance..

4.2.2 Opening RCV adjustments

As part of its business plan South West Water proposed allocations of the RCV for both water resources and bioresources price controls based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale controls and these new controls in accordance with the proportions proposed by South West Water.

We make reconciliation adjustments ('midnight adjustments') related to the company's performance against incentive mechanisms from previous price reviews and for land sales in order to determine the opening RCV for the period of the PR19 controls. We also adjust the RCV upwards to reflect a change in the accounting treatment of leases, which causes some assets formerly recognised as operating leases to be recognised on the company's Balance sheet. In doing so, we follow the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. The company proposed no adjustment in their business plan.

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

	Water resources	Water network plus	Wastewater network plus	Bioresources
RCV – 31 March 2020	1,585.1		1,817.4	
% of RCV allocated by control	8.92%	91.08%	95.57%	4.43%
RCV – 31 March 2020	141.5	1,443.6	1,737.0	80.4
Midnight adjustments to RCV	-8.2	-86.5	-104.7	N/A
Midnight adjustments relating to operating leases	0.0	0.0	0.0	0.0
Opening RCV – 1 April 2020 (before fast track reward)	133.3	1,357.2	1,632.2	80.4

4.2.3 Allowed return on capital

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

South West Water 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 stated in the PR19 methodology. We maintained the early view allowed return on capital for draft determinations for fast track companies. We set out in 'PR19 draft determinations: Overview of fast-track companies' draft determinations' that we would update the allowed return on capital for slow track draft determinations and final determinations.

In its representation to the slow track and significant scrutiny draft determinations, the company sets out that it considers the allowed return on capital has not declined since our early view and provided a consultancy paper from Frontier Economics that estimated a wholesale allowed return of 2.2% - 2.9% (RPI deflated) - higher than the allowed return included in its business plan. We set out our assessment of the issues raised by this consultancy report in the 'Allowed return on capital: technical appendix'.

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	Wastewater network plus	Bioresources	Total
RPI inflated RCV	66.6	678.6	816.1	40.2	1,601.6
CPIH inflated RCV	66.6	678.6	816.1	40.2	1,601.6
Other adjustments	-	-	-	-	-
Total RCV	**133.3**	**1,357.2**	**1,632.2**	**80.4**	**3,203.1**

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

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	61.4	558.3	654.0	26.0	**1,299.7**
CPIH inflated RCV	58.6	534.1	629.6	24.9	**1,247.2**
Post 2020 investment	14.3	300.4	331.1	20.2	**666.0**
Other adjustments	-	1.2	1.4	-	**2.7**
Total RCV	**134.4**	**1,394.0**	**1,616.1**	**71.0**	**3,215.5**

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

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
RPI inflated RCV	6.2	59.3	70.4	3.1	**139.0**
CPIH inflated RCV	9.1	88.1	104.9	4.7	**206.7**
Post 2020 investment	1.2	21.4	27.0	1.5	**51.2**
Other adjustments	-	0.2	0.2	-	**0.4**
Allowed return on capital	**16.5**	**169.0**	**202.5**	**9.3**	**397.3**
Company September 2018 –return on capital	19.5	198.7	237.5	11.3	**467.0**

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 West Water - Allowed revenue appendix' in tables 4.1 to 4.4.

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 and bioresources 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	Wastewater network plus	Bioresources	Total
CPIH inflated RCV	8.0	144.4	186.5	15.4	354.3
RPI inflated RCV	8.2	148.6	195.8	15.7	368.3
Post 2020 investment	1.9	35.1	47.7	2.4	87.1
Total RCV run-off	**18.1**	**328.1**	**430.0**	**33.5**	**809.8**

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

Table 4.10 sets out the average RCV run-off rates across 2020-25 for each wholesale control proposed in the company's business plan and for our draft and final determinations.

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

	Water resources	Water network plus	Wastewater network plus	Bioresources
Company September 2018 (%)	2.67%	4.68%	5.12%	8.40%
Draft determination (%)	2.63%	4.69%	5.12%	8.56%
Final determination (%)	2.64%	4.69%	5.12%	8.54%

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 West Water - Allowed revenue appendix' in table 5.1 to table 5.4. Changes to totex allowances and PAYG rates for each year for individual controls can result in small changes to the average RCV run-off rates presented in the table above.

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

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

For outcome delivery incentives, the information we use to reflect performance in 2019-20 is based on the company's latest expectations. Final figures for 2019-20 will not be able to be taken into account in PR19. We set out in the 'PR14 reconciliation rulebook' that we plan to complete the reconciliation for 2019-20 outcome delivery incentives at PR24 for 2025-30 so that we use final information.

However, most outcome delivery incentives for the 2020-25 period are in period and will have been reconciled before this date. In light of this we consider it would be more appropriate to complete this reconciliation in the autumn of 2020 and apply any change to bills for 2021-22 as part of the new in-period process. We are designating all of the financial PR14 performance commitments as being in-period for this purpose. Any adjustment between the 2019-20 forecast and actual figures should be modest and we do not expect a significant impact on bills. If, contrary to expectations the bill impact is more significant, we expect companies to take measures to smooth the impact for their customers. The new PR19 mechanism to share benefits with customers from unexpected high outcome delivery incentive payments in a year will

not apply to PR14 outcome delivery incentives. Instead the PR14 protection that caps the impact across the five years 2015-20 will apply.

The above applies equally to the company's 2015-20 in period outcome delivery incentives and we use forecast information for 2019-20 to reconcile these outcome delivery incentives. For the avoidance of doubt, no application is required in 2019 for in period determinations.

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

Incentive	Intervention(s)
Outcome delivery incentives	We are intervening to adjust the forecast 2019-20 outperformance payment for the B2 (large scale interruptions) performance commitment for the Bournemouth area to be consistent with the deadband figure stated in the 'Bournemouth Water PR14 final determination company-specific appendix'. Overall, our intervention reduces the water revenue adjustment at the end of the 2015-20 period for South West Water (Bournemouth area) from £1.686 million to £1.658 million.
Residential retail revenue	We are including a figure of 3.85% for the 'Materiality threshold for financing adjustment - Discount Rate' for South West Water and a figure of 3.74% for Bournemouth Water in line with the 'PR14 Reconciliation Rulebook'.
Wholesale revenue forecasting incentive mechanism	No interventions required.
Totex	We are intervening to include figures for water and sewerage baseline totex, water final determination allowed totex and sewerage final determination pension deficit repair costs allowances consistent with those stated in the PR14 final determination company-specific appendices for South West Water and Bournemouth Water. We are also intervening to change the 'Water: Final menu choice' and 'Sewerage: Implied menu choice' figures to full decimal accuracy as calculated in the 'PR14 populated final determination models'. Overall, our interventions for South West Water reduce the water totex RCV adjustment from - £67.194 million to - £63.216 million and wastewater totex RCV adjustment from - £90.599 million to - £90.243 million. Our interventions also increase the water totex revenue adjustment from - £9.916 million to - £10.170 million and wastewater totex revenue adjustment from - £1.867 million to £1.823 million.
Land sales	No interventions required.
Residential retail service incentive mechanism	We are intervening to set South West Water's residential retail service incentive mechanism adjustment to -1.50% of residential retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to - £2.944 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	9.3	9.3	10.3	10.2
Residential retail revenue	N/A	N/A	-4.7	-4.7
Wholesale revenue forecasting incentive mechanism	N/A	N/A	-39.9	-39.8
Totex	-157.8	-153.5	-11.8	-8.3
Land sales	-6.0	-5.9	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	0.0	-2.9
PR09 blind year adjustments[2]	-49.3	-49.3	2.3	2.3
Water trading	N/A	N/A	0.0	0.0
Other adjustments	0.0	0.0	0.0	0.0
Total	-203.8	-199.4	-43.9	-43.3
Total post profiling[3]	N/A	N/A	-47.2	-45.9

[1] The company view is based on data from the 15 July 2019 company submissions. It does not reflect impacts of the subsequent representations. The Ofwat view is based on the 15 July 2019 company submissions and takes account of representations and any interventions we are making.
[2] PR09 blind year adjustments includes the CIS RCV inflation correction. We show these separately in 'South West 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	Wastewater network plus	Bioresources	Total
Fast track reward	0.0	1.8	2.2	0.0	4.1
Tax	0.2	33.8	36.7	2.9	73.6
Grants and contributions (price control)	0.1	43.7	43.5	0.0	87.3
Deduct non-price control income	0.0	-1.2	-0.3	0.0	-1.5

4.4.1 Fast track reward

We awarded fast track status to plans that we considered high quality and that would allow companies to begin implementing that plan. In our draft determination we allowed South West Water a financial reward equivalent to 10 basis points on the return on regulatory equity to recognise the quality of its business plan. South West Water requested that this reward is split evenly between the water network plus and wastewater network plus controls and is split between revenue and RCV adjustment in line with the PAYG rate. Our approach is to calculate the reward using total RCV and spread the reward across water and wastewater in accordance with the opening RCV for the two network controls. We retain this approach for the final determination.

We did not expect fast track companies that had opted into the early certainty principle to raise new cost claims in August 2019. We considered removing South West Water's fast track status over its approach of making additional cost claims, including for the Isles of Scilly, and the allowed return, which was not in keeping with the spirit of our PR19 methodology. We concluded that South West Water had not explicitly been given the opportunity when accepting fast track status to submit additional information regarding the Isles of Scilly cost claim and may not have had sufficient time to arrive at a fully considered position on these costs. We also make

an additional allowance for Knapp Mill and Alderney water treatment works because we did not take into account a query response at draft determination.

We decided that, in the round, the South West Water business plan remained of high quality and it should retain its fast track status and keep its fast track reward.

4.4.2 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 West 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	Wastewater network plus	Bioresources	Total
Tax	0.2	33.8	36.7	2.9	73.6

4.4.3 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 'Cost efficiency technical appendix'. The main difference from draft determinations is that we no longer estimate a cost recovery rate for each company. The starting point for each calculation is 'gross' grants and contributions reported in companies' business plans. To arrive at 'net' grants and contributions we deduct company-specific income offset allowances rather than assume a common recovery rate for all companies. We also apply the modelled base cost efficiency challenge to grants and contributions to ensure alignment between grants and contributions and cost assessment.

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

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

	Water resources	Water network plus	Wastewater network plus	Bioresources	Total
Grants & contributions (price control; before deduction of income offset allowances)	0.1	58.1	47.8	0.0	106.0

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	Wastewater network plus	Bioresources	Total
Grants & contributions (price control)	0.1	43.7	43.5	0.0	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	Wastewater network plus	Bioresources	Total
Grants & contributions (non-price control)	0.0	1.7	4.7	0.0	6.4

4.4.4 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	Wastewater network plus	Bioresources	Total
Non-price control income	0.0	-1.2	-0.3	0.0	-1.5

Note negative numbers represent a deduction from the allowed revenue.

4.4.5 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 West Water does not propose any uncertainty mechanisms.

We are including a PR24 reconciliation mechanism for business rates in our final determination for South West 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 West Water along with all other companies serving England[13] 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

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

increases. Conversely, customers will receive a benefit if outturn costs are lower than the allowance levels we have set.

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 apply our notional dividend yield assumption of 3.00% and with a dividend growth of 1.18% in our notional financeability assessment for South West 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.

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

South West Water is responsible for ensuring it delivers its obligations and commitments in the context of its choice of capital and financing structure. We will monitor the commitments and assurances the company provides about its proposals to maintain financial resilience in 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 West 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[14].

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[15]. 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 West Water in our final determination. The risk ranges show the plausible range of company returns based on South West 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 commitments set in our determinations, our incentive mechanisms also aim to protect customer interests where companies underperform.

South West 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

[14] 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.

[15] 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.

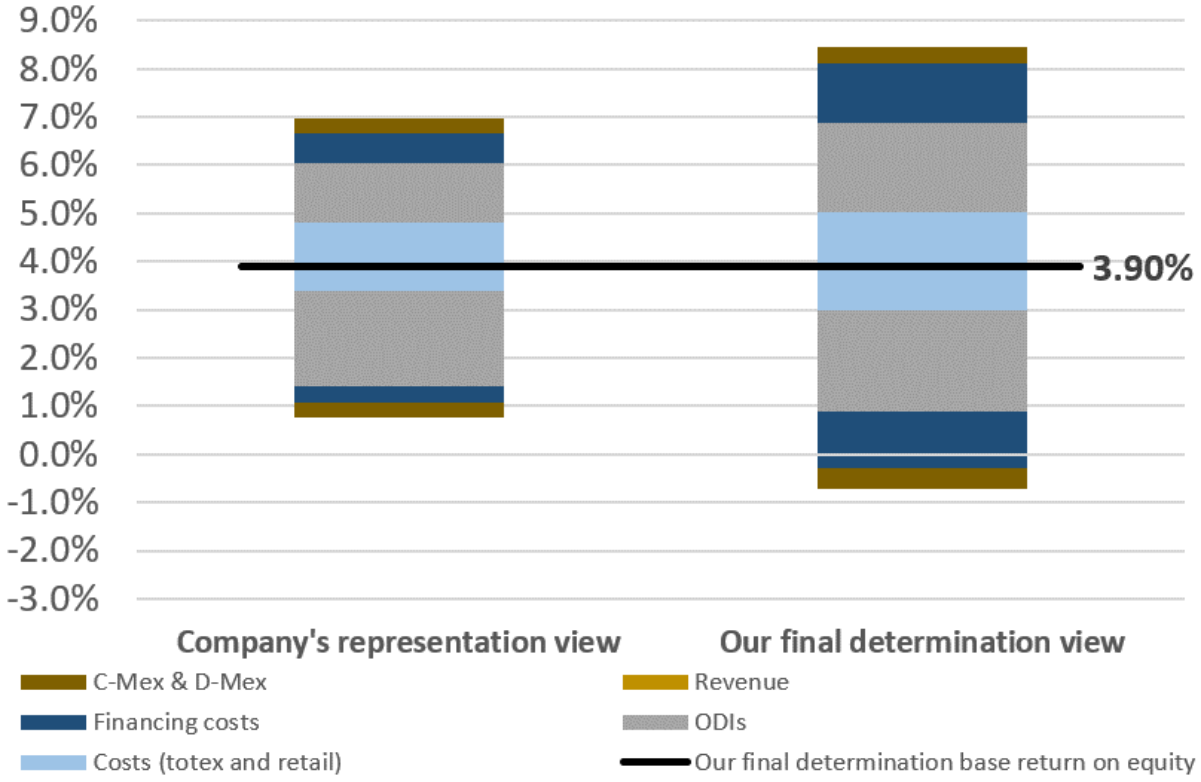
regulatory equity in our final determinations. These risk ranges are not fully comparable with our final determination ranges as they take account of company views of the cost efficiency and outcome delivery incentive stretch in our draft determinations which we revise for the final determinations.

Table 5.1: South West 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	-0.47%	0.88%	-0.86%	1.12%
Outcome delivery incentives	-1.97%	1.25%	-2.12%	1.84%
Financing costs	-0.32%	0.61%	-1.16%	1.23%
Retail costs	-0.05%	0.01%	-0.05%	0.01%
C-MeX and D-MeX	-0.33%	0.31%	-0.45%	0.36%
Revenues (includes Retail)	0.00%	0.00%	0.00%	0.00%
Total	**-3.15%**	**3.06%**	**-4.64%**	**4.56%**

[1] 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 calculate 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 West 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 West 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 business plan, South West Water set out that its 'Board assures that both the notional and actual capital structures remain financeable in the long term, and that key financial ratios area at a level that retain sufficient headroom to maintain investment grade ensuring that resilience and customers interests are maintained in the short and long term'. The company states that its plan targets a credit rating within the boundary of A/BBB+ on a notional basis. South West Water does not maintain a credit rating.

Subsequently, we asked companies to provide additional Board assurance, in their representations in response to our slow track and significant scrutiny draft determinations, that they would remain financeable, taking account of the allowed return on capital in the slow track and significant scrutiny draft determinations and 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 West Water does not comment on the financeability of the draft determination in its representations. However the company states it has reviewed the implied impact of the reduction in the cost of capital and further challenge to cost base and these inevitably have a detrimental impact on the financial ratios and level of headroom for the business to manage financial shocks in the period to 2025.

We have carefully considered the representations made South West Water in relation to the lower allowed return on capital in our final determination. 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[16]. 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 West 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

[16] 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.

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 West 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 West Water.

South West Water makes a representation that we should apply a higher dividend yield to ensure that the gearing level at a notional level is more aligned with the PR19 methodology. Its fast track representations suggest a dividend yield of 4% with 1% growth based on the early view return on capital for the notional structure. In its representations to the slow track draft determinations, it states that this representation remains relevant at the lower allowed return on capital. We set out how we determine an appropriate notional base dividend yield, the circumstances in which we may vary from the base dividend yield assumption and we provide guidance on an appropriate base dividend yield for a company under its actual structure in the 'Aligning risk and return technical appendix'.

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 in the round assessment of notional financeability is made on the basis of the financial ratios from our financial model. It takes account of the evidence that the company provides regarding the levels and thresholds of the financial ratios that underpinned its assurance statement on notional financeability in its business plan (also stated in table 5.2). We note that the Board assurance statement from the company was provided in the context of the original business plan. 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 West 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	61.01%	57.88%	58.40%
Interest cover	4.36	4.73	4.69
Adjusted cash interest cover ratio (ACICR)	1.82	2.00	1.46
Funds from operations (FFO)/Net debt	10.92%	11.93%	11.26%
Dividend cover	1.52	2.16	2.09
Retained cash flow (RCF)/Net debt	7.60%	9.54%	9.13%
Return on capital employed (RoCE)	5.29%	5.37%	4.91%

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 West Water's draft determination adjusted interest cover would be 1.60x.

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

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

	PAYG	RCV run-off	RCV growth
Company (September 2018)	57.6%	4.91%	-0.72%
Draft determinations	59.1%	4.91%	-0.45%

Final determinations	57.4%	4.91%	0.39%
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 West 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 within the final determination to allow the company to continue to meet its interest costs. We estimate 5 year headroom of £120 million above an adjusted cash interest cover of 1.0 times, providing headroom to our totex downside of £61 million and outcome delivery incentives downside of £64 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 West Water is responsible for the financeability of the company and the maintenance of financial resilience under its actual structure. We comment further on the financial resilience of South West Water's actual structure in figure 5.2.

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

South West Water reported gearing of 58.9% at 31 March 2019 and in its business plan it forecasts gearing of 63.7% at 31 March 2021 and 62.1% at 31 March 2025.

The company is not required to procure a formal credit rating under the terms of its licence, instead the company is required to certify, in the opinion of the Board, its key financial ratios are consistent with an issuer credit rating which is an investment grade rating, the company has confirmed that it is continuing to target ratios that are consistent with an investment grade credit rating

The company provided Board Assurance that it was financially resilient in its business plan. In its representations the company states it has reviewed the implied impact of the reduction in the cost of capital and further challenge to cost base and these inevitably have a detrimental impact on the financial ratios and level of headroom for the business to manage financial shocks in the period to 2025.

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.

It is the company's responsibility to maintain its financial resilience under its actual financial structure and as set out in section 7, the company will need to reduce its base dividend yield for 2020-25 in the context of the allowed return and our final determination.

We will closely monitor changes in levels of the company's gearing, other key financial metrics and the certificates that it provides to us in relation to whether it can maintain financial ratios which are consistent with an investment grade credit rating to test that its 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 West Water has committed to assess its financial resilience beyond 2025 in its next long-term viability statement.

6 Affordability and bill profile

Key changes from the draft determination

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

- The pattern of South West Water's average bill profile has not been changed since draft determination.

6.1 Bill profile

South West Water's draft determination contained an average bill profile with a 15% reduction. This reduction excludes the £50 government subsidy for South West Water customers. South West Water expressed satisfaction at draft determination that the bill profile set means that customers' bills will be lower (in real terms) in 2025 than they were 15 years ago. Its final determination bill profile contains a reduction of 20% over 2020–25.

The pattern of South West Water's average bill profile has not been changed since draft determination. It will provide a gradual reduction to provide customers with as much stability as possible in what they actually pay, post inflation (i.e. nominal bills). This is in line with our default approach for the sector, 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.

Table 6.1: Bills in real terms

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company September 2018	£527	£489	£483	£472	£464	£454
Draft determinations	£527	£489	£478	£468	£458	£450
Final determinations – before reprofiling	£527	£460	£454	£437	£428	£419
Final determinations	£527	£458	£449	£439	£430	£422

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 (South West Water was not one of these companies) 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 final determinations for South West Water will cut average bills by 20% in real terms between 2020 and 2025.

In addition, South West Water commits to:

- double the number of customers on support tariffs from 25,000 at the end of the current regulatory period to 50,000 by 2024-25;
- increase its social tariff cross-subsidy from £2 to £9 per customer and jointly fund an extension to its WaterCare 'social' tariff;
- continue income maximisation checks to support customers in identifying unclaimed benefits and states this will bring up household income for beneficiaries by an average of £43 per week; and
- Provide dual billing for all unmetered customers to help customers understand if they would benefit from moving to a water meter.

South West Water has three performance commitments on affordability, which will require it to:

- improve customer views of value for money;
- increase the number of customers receiving social tariffs; and

- reduce the number of customers in water poverty

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	19.2	18.7	19.2	18.9	18.8	**94.8**
Water network plus	210.6	211.6	212.6	209.2	208.9	**1,052.9**
Wastewater network plus	226.8	226.7	224.5	223.4	219.6	**1,120.9**
Bioresources	24.8	24.2	23.3	22.9	22.5	**117.7**
Residential retail	28.5	28.2	27.6	27.0	26.4	**137.7**
Total	**509.8**	**509.3**	**507.2**	**501.4**	**496.2**	**2,524.0**

The water resources, water network plus and wastewater network plus controls are in the form of a percentage limit (inflation plus or minus a number that we determine for each year of the control (the 'K' factor)) on the change in allowed revenue (R) from the previous charging year (t-1). This is based broadly on the formula:

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

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

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

	Base (£m)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	19.2	0.00%	-2.54%	2.67%	-1.54%	-0.23%
Water network plus	210.6	0.00%	0.53%	0.54%	-1.59%	-0.18%
Wastewater network plus	226.8	0.00%	-0.04%	-0.91%	-0.48%	-1.75%

In addition to these controls, we have set a modified average revenue control for bioresources. We recognise that a proportion of bioresources costs are fixed, so we allow for this in setting the average revenue control. The revenue control ensures that where sludge production varies the incremental change in revenues that arises is aligned to incremental costs. The 'modified average revenue' control includes a revenue adjustment factor, which applies if there are differences between the forecast and measured quantities of sludge.

To ensure companies' allowed revenues reflect their costs, we are intervening to implement a standard approach across companies to this classification. We have set out our methodology and our reasons for intervening in the appendix 'Our methodology for the classification of bioresources costs and revenues'. Further details of how we have applied the methodology to South West Water is set out in the 'Bioresources revenue to remunerate fixed costs – South West Water' model.

Table 6.4 sets out our view of the share of revenue to remunerate fixed costs.

Table 6.4: Classification of proportion of revenue to remunerate fixed costs and variable costs for bioresources

	Company view	Ofwat view based on draft determination	Ofwat view based on final determination
Part 1: Revenue to remunerate fixed costs £m 2017-18 FYA CPIH deflated prices (2020-25)			
Total return on capital	N/A	10.8	9.3
Total run-off	N/A	33.8	33.5
Revenue to service RCV	**N/A**	**44.6**	**42.8**
Local authority and Cumulo rates for both treatment and disposal	N/A	3.7	3.7
Fixed share of other direct costs of treatment and disposal	N/A	6.0	6.1
Fixed share of other indirect cost of treatment and disposal	N/A	2.8	2.8
Fixed PAYG revenue	**N/A**	**12.6**	**12.7**
Fixed share of revenue to cover tax	N/A	0.0	0.0
Pension deficit repair contributions	N/A	1.5	1.6
Other fixed costs	**N/A**	**1.5**	**1.6**
Revenue to remunerate fixed costs	**52.5**	**58.6**	**57.2**
Part 2: Variable revenue (£/TDS) 2017-18 FYA CPIH deflated prices (2020-25)			
Unadjusted revenue (£m)	123.1	118.7	117.7
Revenue to remunerate fixed costs	52.5	58.6	57.2
Revenue to remunerate variable costs (£m)	**70.6**	**60.0**	**60.5**
Forecast volume of sludge (TDS)	213,600	213,600	213,600
Variable revenue (£/TDS)	**330.6**	**281.1**	**283.4**

The modified average revenue in each year is calculated by a formula that we set out in the 'Notification of the PR19 draft determination of Price Controls for South West Water', which includes some components set now in this determination and some components which relate to out-turn performance (such as the actual volume of sludge in future years).

Table 6.5: Bioresources control

	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
Unadjusted revenue (£m)	23.2	23.4	23.5	23.7	23.9	117.7
Forecast volume of sludge (TDS)	42,100	42,400	42,700	43,000	43,400	213,600
Variable revenue (£/TDS)	N/A	N/A	N/A	N/A	N/A	283.4

7 Putting the sector in balance

Key points

- South West Water reported gearing of 58.9% as at 31 March 2019. South West Water forecasts that its level of gearing (63.7% by 2021 and 62.1% by 2025) will remain well below the level that triggers 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.
- We expect the company will need to revise its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'.
- 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 West 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[17];
- companies with high levels of gearing share financing gains from high gearing with customers; and
- companies provide assurance and supporting evidence to demonstrate their long-term financial resilience and management of financial risks for the actual financial structure, taking account of their future investment needs.

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

In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return: technical appendix'.

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

Table 7.1: Our assessment of South West 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 confirmed it would implement our default gearing outperformance mechanism, though the company forecasts that its gearing level through 2020-25 will remain well below the threshold that triggers the mechanism.
Voluntary sharing mechanisms South West Water proposes a cost of embedded debt outperformance sharing mechanism. Outperformance is defined as the difference between average annual outturn on the iBoxx A/BBB and the cost of new debt allowance for PR04 and PR09. Where the cost of new debt is higher, sharing payment is the percentage difference multiplied by 25% of outstanding debt (25% being an estimation of new debt raised in each control period). South West Water has estimated that this sharing is worth £20 million over 2020-25.
Dividend policy for 2020-25 South West Water confirms that it is committed to meet the expectations on dividend policy as set out in our 'Putting the sector in balance' position statement but under our current assessment it falls short in a number of areas as set out below. Its fast track representations indicate a 5.5% base dividend yield above the level set out in our position statement. We expect the company will need to revise its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'. 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).

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

Our assessment of the company's proposals to balance the interests of customers

The company confirms that the outturn dividend yield would depend on whether the company has delivered on its commitments to customers, but provides insufficient detail on the specific obligations and commitments to customers that will be considered. The company confirms that the level of performance delivery considered will be as set out in the final determination. It confirms that dividends can be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid.

The company commits that its annual performance report will explain how its dividend is consistent with its dividend policy. The company will also continue to discuss its dividend policy with the independent WaterShare+ Panel and seek endorsement from them for any changes proposed and report the outcome of any engagement.

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 this can be expected to vary depending on the scale of a company's RCV growth and future investment needs. We set out further details in 'Aligning risk and return technical appendix'.

We expect South West 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.

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 West 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 West Water's policy on performance related executive pay to demonstrate a substantial alignment to the delivery of service for customers throughout 2020-25.

South West Water states it is committed to meet the expectations set out in our 'putting the sector in balance' position statement. South West Water has confirmed that its Remuneration Committee has discussed and approved the following policy:

- The annual bonus will be based on (i) 70% weighting linked to specific customer delivery targets, underpinned by an expectation that performance related pay will be made only if at least 90% of a basket of outcome delivery incentives to customers are met, (ii) 10% weighting to personal objectives, including delivery of the 'New Deal', and (iii) 20% weighting linked to financial delivery targets that support financial sustainability (10% Profit before tax and 10% net debt / gearing).
- The long-term incentive will apply equal weighting to (i) RoRE outperformance (based on the Final determination), (ii) sustainable dividend measures and (iii) C-Mex. An underpin applies which will allow the Remuneration Committee to reduce or withhold vesting if it is not satisfied with the underlying operational and economic performance of the company. Malus and clawback arrangements will also be in place.
- The South West Water Remuneration Committee will oversee in the first instance the monitoring and application of its Executive Pay policy, with the potential from 2020 of the Independent Customer Challenge Panel having role in monitoring the policy.
- In addition to reporting through the annual report and accounts, information will be disseminated to the Customer Challenge Panel, through a customer oriented document.

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.

Our assessment of the company's proposals to balance the interests of customers
We expect South West 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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