

December 2019

PR19 final determinations

**Wessex Water – Aligning risk and return
final decisions**

PR19 final determinations: Wessex Water - Aligning risk and return final decisions

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

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

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

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

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

Table 1: Wessex Water – Representations in response to the draft determination

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	WSX.RR.A1	The company should revise its business plan and associated financial modelling to be based on our ‘early view’ of cost of capital or provide compelling evidence why this is not appropriate.	No intervention required. We have reviewed Wessex Water’s updated business plan and the company has provided sufficient evidence that it has used the cost of capital from our ‘early view’ in the PR19 final methodology.	No change for the final determination.	N/A	N/A
Risk and return	WSX.RR.A2	The company should provide further evidence of the assumptions used to derive the notional company when	No intervention required. Wessex Water has completed the required action.	No change for the final determination.	N/A	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		calculating the financial ratios provided in the business plan tables or provide further ratios consistent with the PR19 financial model for the notional company as set out in the methodology.				
Risk and return	WSX.RR.A3	The company should reassess financeability on its actual structure and provide a board statement based on a business plan underpinned by an appropriate cost of capital. The company should set out the steps taken and the assurance obtained by the board in order to provide the statement, including, with supporting evidence, the threshold levels for key financial ratios.	<p>Intervention required.</p> <p>Wessex Water has provided further evidence in relation to the action including an updated Board statement that the company is financeable on the notional and its actual company structure.</p> <p>On its actual structure, the company has targeted credit ratings of Baa1 (Moody's) and BBB+ (Fitch). We note that the company targets a threshold for FFO/Debt for S&P at > 6% which is lower than the threshold of 9% set out in S&P's recent rating affirmation for Wessex Water (November 2018). We also note that the actual FFO/Net debt ratios average <9% in the business plan.</p> <p>We expect Wessex Water to provide further evidence to support the Board's assurance that the company is financeable in relation to its actual company structure and should set out the steps to be undertaken to address the weak FFO/Debt ratio relative to the target credit rating of BBB+ for S&P, taking account of our draft determination.</p>	<p>Representation made.</p> <p>The company provides representations that the Board is not able to provide assurances on the financial resilience of the company under the draft determination or any further reductions to the allowed cost of capital.</p>	<p>No change for the final determination.</p> <p>We retain our overall approach to the assessment of financeability. We carry it out in our financial model, on the basis of the notional capital structure on which we derive our allowed return on capital and we assume each company is able to achieve the benchmarks in our determinations.</p> <p>Consistent with the PR19 methodology and our approach in the draft determination, we advance revenue from future customers where a financeability constraint arises to ensure the final determination is financeable on the basis of the notional capital structure.</p>	We discuss our assessment of financeability in the 'Wessex Water final determination' and the basis on which we consider Wessex Water's final determination to be financeable on the basis of the notional capital structure.
Risk and return	WSX.RR.A4	The company should provide further evidence of how a 'robust investment grade' credit rating is appropriate for the notional and its actual company structure in relation to its investment needs, the approach of credit rating agencies, its current credit rating or the licence requirement to maintain a	<p>No intervention required.</p> <p>Wessex Water has completed the action.</p> <p>The company has set out that the company targets credit ratings of Baa1/BBB+ (Moody's/Fitch) for the</p>	Representation made as per action WSX.RR.A3.	As per WSX.RR.A3.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		minimum investment grade credit rating.	notional and its actual company structure, in line with the 'robust credit rating' targeted in the original business plan. However, we expect the company to respond to action WSX.RR.A3			
Risk and return	WSX.RR.A5	The company should ensure consistency of the information on RoRE analysis submitted in App26 and elsewhere in its plan, or reconcile the differences between the third party report and the data submitted in business plan table App26.	No intervention required. The company has responded satisfactorily to the action.	No change for the final determination.	N/A	N/A
Risk and return	WSX.RR.B1	The company should provide a clearer link between its internal risk management and mitigation procedures and the RoRE analysis.	No intervention required but Wessex Water should consider responding to this advised action. Wessex Water should address this action in its response to our draft determination.	Representation made. In its representation on the draft determination, Wessex Water sets out that its analysis of financial resilience, including financial viability, is undertaken using the outputs from its company risk register and incorporates additional wider macro-economic factors such as inflation, cost of debt, productivity and input prices. Wessex Water says that the company's RORE analysis for PR19 is integrated into and consistent with the financial viability analysis and therefore takes full account of current and foreseeable risks and their mitigation.	No change for the final determination.	N/A
Risk and return	WSX.RR.C1	In the original business plan, Wessex Water states its approach to revenue recovery is that 'the company is funded for all wholesale operating expenditure and all infrastructure renewals and repairs on a PAYG basis' and in its response to the IAP stated that 'we have updated PAYG rates to reflect the revised totex programme'. However, it appears that the company has not taken into account the deduction for grants and contributions allocated to operating	We are making a technical intervention to align PAYG rates to Wessex Water's stated approach of recovering all wholesale operating expenditure and all infrastructure renewals and repairs expenditure net of grants and contributions within operating expenditure.	Representation made. The company provides representations that the financial ratios within the draft determination are incorrect due to the modelling of opex/capex and plausibly wrong in its ex-ante determination assumption. The company states that for the final determination Ofwat should return to	Change for the final determination. A number of companies and stakeholders have made similar representations in relation to the proportion of operating expenditure in cost allowances and the determination of PAYG rates. We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.	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

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		expenses in the calculation of PAYG rates for water and wastewater network plus controls.		calculating the PAYG as per the natural rates.		<p>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.</p> <p>We set out the specific interventions we make for Wessex Water in relation to notional financeability in the 'Wessex Water final determination' document.</p>
Risk and return	WSX.RR.C2	We considered the RoRE risk range for financing new debt included by Wessex Water in its business plan submission to be excessive, taking account of our analysis of sector bond issuance costs since April 2015, compared to our benchmark index.	For the draft determination we are intervening to reduce Wessex Water's financing risk range associated with the cost of new debt to 100 bps on the upside and 25 bps on the downside. This intervention is consistent with the PR19 methodology. However, as set out in the 'Aligning risk and return technical appendix', we are considering the assessment of debt cost risk further for the final determination.	<p>No representation made.</p> <p>However, the company disagrees with the 'halo' adjustment we apply in our determination of debt costs and considers that the assumed proportion of new debt for a notional company should be lower than 20%.</p>	Change for the final determination.	See WSX.RR.D4
Risk and return	WSX.RR.C3	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. This approach seeks to take account of covariance in performance on individual outcome delivery incentives.	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework.	<p>Representation made.</p> <p>In its representation on the draft determination, Wessex Water sets out a view that its overall return on regulated equity (RoRE) range for ODIs is now significantly skewed to the downside which is misaligned with the PR19 methodology.</p>	Change for the final determination.	See WSX.RR.D4
Risk and return	WSX.RR.C4	We expect companies to update their RoRE risk range analysis in response to the draft determinations.	We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the 'Aligning risk and return technical appendix' that accompanies our draft determination and 'Technical appendix 3: aligning	<p>Representation made.</p> <p>Wessex Water provides updated views on RoRE risk ranges in its representation.</p> <p>In its representation on the draft determination, Wessex Water expressed a view that we had not</p>	Change for the final determination.	<p>In our final determination for Wessex Water we:</p> <ul style="list-style-type: none"> Increase performance commitment levels on mains repair and amend the underperformance payment rate to industry average to provide a more balanced spread of incentives and risks

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			<p>risk and return' published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the company, taking account of the company's reported level of actual performance delivered in 2015-19 and taking account of the steps it is already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk.</p>	<p>accurately reflected P10 and P90 risk ranges in light of the interventions in our draft determination. Wessex Water referred to its ODI risk range in particular which it considers is significantly skewed to the downside and inconsistent with the broadly symmetrical ODI risk ranges referred to in the PR19 methodology. The company does not consider that performance commitments have been set at P50 levels.</p> <p>We present our assessment of the RoRE risk range provided by the company in its representation in the 'Wessex Water company specific appendix' which presents a slight downward skew to the overall risk range relating to totex risk and outcome delivery incentives.</p>		<p>across performance commitments;</p> <ul style="list-style-type: none"> • make the outcome delivery incentive for the new event risk index reputational; • increase the water supply interruptions 2024-25 level which makes it more achievable; and • amend the deadband on the Compliance Risk Index, reducing the risk of underperformance payments in the last three years of 2020-25. <p>Further information is provided in the 'Wessex Water company specific appendix'.</p>
Securing confidence and assurance	WSX.CA.A5	<p>On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'putting the sector in balance: position statement' to include:</p> <ul style="list-style-type: none"> • commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends. <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.</p>	<p>No intervention but further action needed by Wessex Water.</p> <p>We expect Wessex Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination.</p> <p>We expect the company to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer</p>	<p>Representation made.</p> <p>The company provides some additional information in response to our action. The company sets out how its dividend policy for 2020-25 will take account of obligations and commitments to customers and other stakeholder but it provides insufficient detail on the specific obligations and commitments to customers that will be considered and the levels of performance delivery they will be considered against. When explaining how performance delivery will impact on dividends paid, the company has solely focused on the financial impact of penalties and rewards, in relation to performance commitments and not the wider impact of obligations and commitments to customers and other stakeholders.</p>	<p>Change for the final determination.</p> <p>We have updated our assessment of the reasonable base dividend for water companies in 2020-25 as set out in the 'Aligning risk and return technical appendix'.</p> <p>Under our current assessment the company falls short in a number of areas set out below. We expect Wessex Water to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25 and demonstrate how it has taken account of obligations and commitments to customers and other stakeholders, including;</p> <ul style="list-style-type: none"> • the specific obligations and commitments considered under the policy, • how it has delivered against performance levels as set out in 	<p>We expect Wessex 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 'Aligning risk and return technical appendix'.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			to the examples of best practice we have identified among companies.		the final determination and elsewhere, and how performance delivery has impacted on the dividends paid.	
Securing confidence and assurance	WSX.CA.A6	<p>On executive pay the company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'putting the sector in balance: position statement' to include:</p> <ul style="list-style-type: none"> visibility and evidence of substantial linkage of executive remuneration to delivery to customers; clear explanation of stretching targets and how they will be applied; clearer explanation of how the policy will be rigorously applied and monitored; commitment to report how changes, including the underlying reasons, are signalled to customers; and commitment to publish the executive pay policy for 2020-25 once it has been finalised. <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.</p>	<p>No intervention but further action needed by Wessex Water</p> <p>There remain some details to be finalised, for example details of the underlying metrics and associated weightings in the annual bonus. Once finalised, we expect Wessex Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'putting the sector in balance: position statement'.</p> <p>We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.</p> <p>We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.</p>	<p>Representation made.</p> <p>In its response the company has provided some additional information to that previously provided.</p> <p>It states that its remuneration committee would agree further details of the proposed performance related pay package that will apply from April 2020. The targets themselves will be agreed at the remuneration committee's meeting in March 2020 and annually thereafter, and will have regard to any targets that are agreed as part of a final determination by that point and to performance of relevant comparator companies.</p>	<p>Change for the final determination.</p> <p>Wessex Water states that it is committed to meet the expectations set out in our 'Putting the sector in balance: position statement'. Based on our calculations, the overall percentage of alignment of incentives to customers is in line with the 60% we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'. However we consider that there is scope for the company to improve this position.</p>	<p>We expect Wessex Water to be transparent when explaining and reporting the application of its performance related executive pay policy over 2020-25, to demonstrate how it exhibits a substantial alignment to the delivery of service for customers and meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Tax	N/A	N/A	N/A	Representation made. Wessex Water provides two sets of revised tax information in its representation, to reflect changes to totex in the draft determination and additionally to reflect its view of capital expenditure.	Change for the final determination. As the amount of capital expenditure allowed in the final determination is closest to the amount allowed in the draft determination, we accept the information provided by the company in appendix R4.1.	We reflect the updated capital allowance information on tax in appendix R4.1` provided by Wessex Water in our final determinations
Securing long-term resilience	WSX.LR.C1	The Board assurance on actual and notional financeability and financial resilience in the revised business plan was provided on the basis of the assumptions made in the business plan, prior to any interventions we have made in the draft determination and our updated view of the cost of capital. There is evidence of further downward pressure on the cost of capital in very recent market data which will be considered for our final determination.	We expect companies to provide further Board assurance, in their responses to the draft determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Allowed return on capital technical appendix'.	Representation made Wessex Water says that its board is unable to provide assurance that the company will remain financeable on a notional and actual basis. It is also unable to provide assurance that the company can maintain the financial resilience of its actual structure taking account of the reasonably foreseeable range of plausible outcomes in its final determination, including evidence of further downward pressure on the cost of capital. The company sets out that its board is fully aware of the company's licence duties and obligations and is considering all the options it has available to it to secure financial resilience and is making all appropriate preparations. These include the company's representations on the draft determination. Wessex Water also sets out that analysis of financial resilience, including financial viability, is undertaken using the outputs from its corporate risk register and incorporates additional wider macro-economic factors such as inflation, cost of debt, productivity and input prices. It says that its RORE analysis for PR19 is integrated into and consistent with its financial viability analysis, taking account of current and foreseeable risks and their mitigation.	No change for the final determination We consider that our determinations are financeable for an efficient company with a notional capital structure. However, there is also a need for companies to ensure that that they are financially resilient under their actual structures. 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. Therefore, on account of Wessex Water's gearing which is above the notional level, the cost of capital in our final determinations that is lower than the draft determinations, the company may need to take steps to maintain its financial resilience in 2020-25.	We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25 to test that adequate steps are being taken by management and that financial resilience is being maintained. In its future reporting, we expect the company to explain clearly in its long term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks. Wessex Water has committed to assess its financial resilience beyond 2025 in its next long term viability statement.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				Wessex Water has committed to assess its financial resilience beyond 2025 in its next long term viability statement		

Table 2: Wessex Water – Changes to the draft determination that are not in response to an action or representation

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

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
		<ul style="list-style-type: none"> • Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices. <p>We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for Wessex Water along with all other companies serving England because:</p> <ul style="list-style-type: none"> • 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. 	<p>than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.</p>

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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