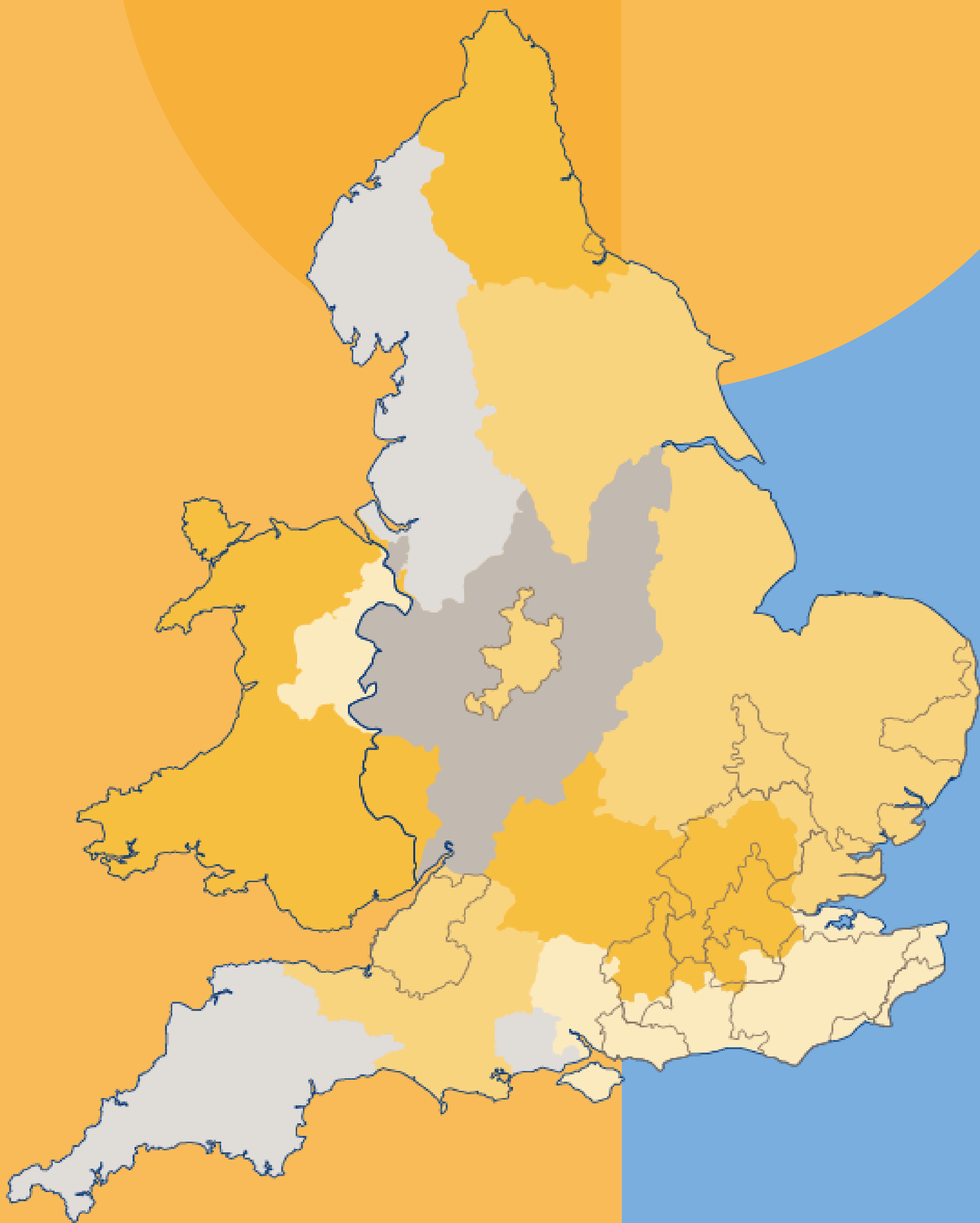
July 2019

Trust in water

PR19 draft determinations

South Staffs Water draft determination



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PR19 draft determinations: South Staffs Water draft determination

About this document

This document, together with the 'Notification of the draft determination of price controls for South Staffs Water', sets out for consultation the details of the draft determination of price controls, service and incentive package for South Staffs Water for 2020 to 2025. All figures in this document are in 2017-18 prices except where otherwise stated.

The draft determination sets out:

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

The draft determination covers three price controls for the 2019 price review (PR19):

- water resources;
- water network plus; and
- residential retail.

This draft determination is in accordance with our PR19 methodology, our statutory duties and the UK Government's statement of strategic priorities and objectives for Ofwat. 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.

All of the responses to the initial assessment of business plans, including all of the companies' revised business plans, provided by 1 April 2019 are taken into account in our decisions where relevant. Where appropriate, we explicitly set out our response to points and issues raised by respondents.

Our decisions also take into account the representations made on the fast track draft determinations where points and issues raised are relevant to the slow track and significant scrutiny draft determinations. We will deal with the other elements of the representations on the fast track draft determinations as part of the final determinations.

We have not necessarily been able to take full account of all late evidence, submitted after 1 April 2019 business plans, and we will consider this information for the final determination.

The appendices to this document provide more detail and form part of the draft price control determination:

- PR19 draft determinations: South Staffs Water - Cost efficiency draft determination appendix

- PR19 draft determinations: South Staffs Water - Outcomes performance commitment appendix
- PR19 draft determinations: South Staffs Water - Accounting for past delivery appendix
- PR19 draft determinations: South Staffs Water - Allowed revenue appendix

For all other documents related to the South Staffs Water draft determination, please see the draft determinations webpage.

How to respond

Written representations on the draft determinations should be provided to us by 10am on 30 August 2019. Representations can be made by all stakeholders. Representations can be sent either to our PR19 inbox (PR19@Ofwat.gov.uk) or by post to our Birmingham office address: Ofwat, Centre City Tower, 7 Hill Street, Birmingham, B5 4UA.

To ensure transparency, we expect companies to publish their representations in full. We also intend to publish all the written representations we receive on our website once our final determinations are made.

In view of this, if respondents consider that some of the information in their representations should not be disclosed (for example, because they consider it is commercially sensitive information) they should identify that information and explain why. We would expect strong, robust reasons that are specific to the information concerned. We will take such explanations into account, but we cannot give an assurance that information included in representations will not be disclosed.

Where companies are making representations, they should consider what further evidence may be necessary to submit with their representations as a result of this draft determination. Where companies consider that we have not appropriately considered any points previously raised by the company, companies should include this within their representations. Companies should provide a completed ‘All company representation pro forma’ alongside any representations.

We will publish South Staffs Water’s final determination on 11 December 2019 after considering representations (from all stakeholders) on the draft determination and other relevant matters. If South Staffs Water accepts the final determination, it will be accepting that it has adequate funding to properly carry out the regulated business, including meeting its statutory and regulatory obligations, and to deliver the outcomes within its final determination.

Contents

1 Summary

Through PR19 we are enabling, incentivising and challenging water companies to address the key issues facing the sector of climate change, a growing population and ever increasing customer expectations about service. We expect companies to look well beyond the five year price review period to meet needs of future customers and protect and improve the natural environment.

Our PR19 methodology set out a framework for companies to address these challenges, with particular focus on improved service, affordability, increased resilience and greater innovation. Our draft determinations are based on our detailed review of the revised plans submitted to us on 1 April. We are intervening, where required, to protect customers.

1.1 What the draft determination will deliver

Our draft determination for South Staffs Water will cut average bills by 17.3% in real terms in the 2020-25 period compared to the company's proposed 8.9% reduction. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in April 2019 and our draft determination. Average bills are lower than proposed by South Staffs Water, reflecting our view of efficient costs. Further details are set out in section 6.

Table 1.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan (April resubmission)	£140	£138	£135	£133	£130	£128
Draft determination	£140	£125	£122	£120	£118	£116

Our draft determination allows South Staffs Water £97 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £63 million to improve resilience at Hampton Loade and Seedy Mill water treatment works which will improve taste odour and colour of customers' water; and
- £11 million to address the impacts of deteriorating raw water quality.

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

Our draft determination package includes a full set of performance commitments, specifying the minimum level of service that South Staffs Water must commit to deliver for customers and the environment. Each performance commitment also has a financial or reputational incentive to hold the company to account for delivery of these commitments.

The performance commitments require South Staffs Water to deliver service improvements by reducing water supply interruptions and customer contacts about the appearance, taste and odour of water. South Staffs Water will deliver environmental benefits by reducing carbon emissions, per capita consumption and leakage. The company will also provide more support for vulnerable customers by 2024-25. Further details of performance commitments are set out in Table 1.2 below and in section 2.

Table 1.2: Key commitments for South Staffs Water

Area	Measure
Overall incentive package	Overall, the likely range of returns from the outcome delivery incentive package equates to a return on regulatory equity range of - 2.72% (P10) to + 0.43% (P90).
Key common performance commitments	• 23% reduction in annual level of leakage by 2025 from the 2020 level[1] (15% in Cambridge region and 25% in South Staffs region). • 1% reduction in per capita consumption by 2024-25 in South Staffs region, 6.3% reduction in Cambridge region. • 57% reduction in water supply interruptions by 2024-25
Bespoke performance commitments	• 396% increase in the area of land that the company actively manages to protect wildlife, plants, habitats and catchments by 2024-25. • 12% reduction in the amount of direct or indirect operational carbon emissions as a result of our operations, per connected property by 2024-25. • 38% reduction in the number of customer contacts received each year about the appearance, taste and odour of water, or perceived illness by 2024-25.

Note: The calculations behind these numbers are outlined in the 'South Staffs Water - Outcomes performance commitment appendix'

1.2 Allowed revenues

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

[1] Whilst the figures in the tables of the 'South Staffs Water - Outcomes performance commitment appendix' which relate to this performance commitment reflect that it is measured on a three-year average to smooth annual variations due to weather, the overall performance commitment target is a reduction in average annual leakage of 23% (from 2019-20 baseline) by 2024-25.

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

	Water Resources	Network plus - water	Wholesale Total	Residential retail
Final allowed revenues (£ million)	45.9	460.1	**505.9**	63.9

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

As set out in the 'Cost of capital technical appendix', we are updating our assessment of the cost of capital for South Staff Water's draft determinations. The updated cost of capital is 3.19% (on a CPIH basis, 2.19% on a RPI basis) at the level of the Appointee, a reduction of 0.21% from our early view set out in the PR19 methodology.

We consider that South Staffs Water's draft determination is financeable, based on an efficient company, with the notional capital structure, and is sufficient to deliver its obligations, including to ensure a long term resilient service. Each company is responsible for ensuring its capital and financial structure allows it to maintain financial resilience over the short and the long term. We expect South Staffs Water to take account of this requirement and 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. We expect South Staffs Water to provide appropriate Board assurance that it will remain financeable on a notional and actual basis and can maintain its long term financial resilience in its response to our draft determination. Further detail on our assessment of financeability is set out in section 5.

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 Staffs Water has committed to meeting the expectations set out in our 'Putting the sector in balance position statement'. We expect the company to apply our default mechanism and to use our definition of gearing in the outperformance mechanism. However, we expect the company to continue to take steps in these areas to meet our expectations so that customers can have more trust in the water sector. This includes demonstrating that its dividend policy will take account performance against commitments made to customers and that its policy on performance related executive pay has a substantial link to stretching performance delivery for customers through 2020-25.

In the 'Putting the sector in balance' position statement, we also encouraged companies to adopt voluntary sharing mechanisms, particularly where, for example, companies outperform our cost of debt assumptions. South Staffs Water has not proposed any voluntary sharing mechanisms. However, it provides a hardship fund to customers.

1.3 Where we intervene

Our initial assessment of South Staffs Water's plan on 31 January 2019 assessed the plan as slow track. We identified a number of areas where material interventions were required to protect customers' interests. In its 1 April 2019 revised business plan, South Staffs Water has not adequately addressed our concerns. In our draft determinations, we intervene in South Staffs Water's plan in the following areas:

- We align total expenditure (totex) allowances to our view of efficient costs using the comparative information available to us, as it did not provide convincing evidence to explain why its proposed costs were higher. This intervention reduces South Staffs Water totex costs by 10.5%, a substantial reduction, and saves customers £69 million.
- We do not allow enhancement expenditure for leakage as the company is not forecasting to go beyond upper quartile performance). South Staffs Water must deliver this performance commitment at no additional cost to customers, with outperformance rewarded through the outcome delivery incentive framework.
- We adjust the bill profile so that it provides an initial fall in 2020-21, and then remains flat in nominal terms.
- We alter end-of-period outcomes incentives to make these in-period, with performance more rapidly reflected in customer bills.
- We substantially increase performance on some common performance commitments such as reduction in per capita consumption to reach upper quartile in the Cambridge region.
- We increase the incentive rates on performance commitments such as leakage.
- We reject South Staffs Water's proposal to exclude two major water treatment works from the Compliance Risk Index.
- We include the Ofwat definition of gearing for the purpose of gearing benefit sharing.
- We remove £15 million of Pay as you go (PAYG) revenue that South Staffs Water proposed to bring forward from future customers as it did not provide sufficient evidence that this would strike a fair balance of cost recovery between current and future customers.

We set out further detail of our interventions in this document and in the South Staffs Water actions and interventions documents.

2 Outcomes

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

The 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 expect 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 continue our assessment of customer engagement evidence following each company's submission of its response to our initial assessment of its plan in April 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.

Although we note that South Staffs Water uses a top-down approach to set outcome delivery incentive rates in its 3 September plan, we otherwise find that the company demonstrates good quality and sometimes innovative customer engagement in many areas, such as: effective use of a wide range of customer engagement techniques; two-way dialogue with customers and use of comparative information; the approach to adopting the four areas of customer participation action in the Tapped In report ('futures', 'action', 'community', 'experience'); on longer term issues through 'in the moment' bill impacts, 'Top Trump' style games to test supply versus demand, voice overs and video content.

The company has updated parts of the original plan in response to our initial assessment, explaining that it has 'carried out more specific engagement with customers on incentives, including the use of caps, collars and rewards'. We note that the same research included customers' view of bill profiles for the next and following price review periods. We find the recent research, which uses an online survey and in-home interviews, to be of a satisfactory quality, although we do not accept the conclusions on customers' bill profile preferences (see section 6.1 of this document for more information).

South Staffordshire Water's customer challenge group states in its 1 April 2019 assurance report that 'we consider that the company has done its best to address areas of challenge in the [initial assessment] by carrying out follow-up research which confirms customer support for its proposals on outcomes and price'. We note that the customer challenge group adds 'The follow-up research reinforces the evidence that customers prefer end-of-period adjustments, even after the alleged benefits of in-period payment have been explained to them. The [customer challenge group] supports the company's compliance with customer preference on this matter'.

The customer challenge group comments that it has not been possible in the time given to consider all the actions related to outcome delivery incentives and challenges the regulatory view on RoRE ranges.

2.2 Performance commitments and outcome delivery incentives

South Staffs Water's performance commitments and outcome delivery incentives for the 2020-25 period are listed in Table 2.2 and Table 2.3. The detail of these performance commitments and outcome delivery incentives are set out in the ‘South Staffs Water - Outcomes performance commitment appendix’. The performance commitments and outcome delivery incentives include the revisions accepted by the company in response to our 31 January 2019 initial assessment of business plans and any additional interventions we are making in the draft determination.

The material interventions we are making in the draft determination are set out in Table 2.1 below. ‘South Staffs Water – Delivering outcomes for customers actions and interventions’ sets out in detail our interventions in the company’s performance commitments and outcome delivery incentives following our 31 January 2019 initial assessment of plans.

Table 2.1: Summary of key interventions on outcomes

Intervention description
Accepting the company's target to deliver a 23% reduction in leakage (15% in Cambridge and 25% in South Staffs), which is the fifth highest reduction and will reduce the gap to industry upper quartile by 2024-25. Increasing underperformance and outperformance rates in relation to leakage, as the company's proposed rates are lower than the industry average and their own PR14 rates.
Accepting the company's proposal to deliver a 1% reduction in per capita consumption in its South Staffs region, to maintain its upper quartile performance there, and increasing the reduction to 6.3% of per capita consumption in its Cambridge region (which is the upper quartile reduction for that area), by 2024-25. Decreasing underperformance and outperformance rates in relation to per capita consumption to make them reflective of the outputs of the company's customer research.
Increasing the company's proposed reduction for water supply interruptions performance levels from 45% to 57%, to take it to forecast industry upper quartile by 2024-25. We are setting an industry wide glide path for all years before 2024-25. Increasing the underperformance rate in relation to water supply interruptions to ensure sufficient customer protection. We are also increasing the outperformance rate to appropriately balance incentives.
Removing the company's proposed exemptions relating to compliance for water quality (Compliance Risk Index) at two sites and their associated networks, as we do not find the company's justification plausible. Increasing the underperformance rate in relation to compliance for water quality (Compliance Risk Index), given the company's comparatively low proposed rates and recent poor performance.
Accepting the company's proposals for the performance commitment which measures the number of hectares benefiting from the company's catchment management activity.
Accepting the performance commitment which measures the length of time taken to fix visible leaks based on the quality of evidence provided by the company.
Accepting the approach followed by the company in relation to adopting our initial assessment of plans' proposed definition and its forecast performance improvement in water quality contacts which is better than industry upper quartile percentage improvement. Increasing underperformance and outperformance rates in relation to water quality contacts given the company's comparatively low proposed rates and recent poor performance.

Table 2.2: Summary of performance commitments: common performance commitments

Name of common performance commitment	Type of outcome delivery incentive	Price controls outcome delivery incentives will apply to
Water quality compliance (CRI) [PR19SSC_D1]	Financial - Under; In-period	Water network plus
Water supply interruptions [PR19SSC_D2]	Financial - Out & under; In-period	Water network plus
Leakage South Staffs region [PR19SSC_C1]	Financial - Out & under; In-period	Water network plus
Leakage Cambridge region [PR19SSC_C2]	Financial - Out & under; In-period	Water network plus
Per capita consumption South Staffs region [PR19SSC_C3]	Financial - Out & under; In-period	Water network plus
Per capita consumption Cambridge region [PR19SSC_C4]	Financial - Out & under; In-period	Water network plus
Mains repairs [PR19SSC_D4]	Financial - Out & under; In-period	Water network plus
Unplanned outage [PR19SSC_D5]	Financial - Out & under; In-period	Water resources; Water network plus
Risk of severe restrictions in a drought [PR19SSC_D3]	Reputational	N/A
Priority services for customers in vulnerable circumstances [PR19SSC_B4]	Reputational	N/A
C-Mex: Customer measure of experience [PR19SSC_A1]	Financial - Out & under; In-period	Residential retail
D-Mex: Developer services measure of experience [PR19SSC_A2]	Financial - Out & under; In-period	Water network plus

Table 2.3: Summary of performance commitments: bespoke performance commitments

Name of bespoke performance commitment	Type of outcome delivery incentive	Price controls outcome delivery incentives will apply to
Retailer measure of experience [PR19SSC_A3]	Reputational	N/A
Financial support [PR19SSC_B1]	Financial - Under; In-period	Residential retail
Extra Care assistance [PR19SSC_B2]	Financial - Under; In-period	Residential retail
Education activity [PR19SSC_B3]	Financial - Out & under; In-period	Water resources; Water network plus
Environmentally sensitive water abstraction [PR19SSC_C5]	Financial - Out & under; In-period	Water resources
Supporting water efficient housebuilding [PR19SSC_C6]	Reputational	N/A
Protecting wildlife, plants, habitats and catchments [PR19SSC_C7]	Financial - Out & under; In-period	Water resources; Water network plus
Carbon emissions [PR19SSC_C8]	Reputational	N/A
Customer contact about water quality [PR19SSC_D6]	Financial - Out & under; In-period	Water network plus
Visible leak repair time [PR19SSC_D7]	Financial - Out & under; In-period	Water network plus
Water treatment works delivery programme [PR19SSC_D8]	Financial - Under; In-period	Water network plus
Bad debt level [PR19SSC_E1]	Reputational	N/A
Residential void properties and gap sites [PR19SSC_E2]	Financial - Under; In-period	Residential retail
Employee engagement [PR19SSC_E3]	Reputational	N/A
Treating our suppliers fairly [PR19SSC_E4]	Reputational	N/A
Trust [PR19SSC_F1]	Reputational	N/A
Value for money [PR19SSC_F2]	Reputational	N/A
WINEP Delivery [PR19SSC_NEP01]	Reputational	N/A

Figure 2.1 and Figure 2.2 below provide an indication of the financial value of each of South Staffs Water's outcome delivery incentives (taking into account the impact of our draft determination interventions) 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 over performed to the P90 level. The figures cover common and bespoke commitments respectively.

Table 2.4 below 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 regulated equity)) and the overall impact of our draft determination interventions. The estimates are based on the company's own view of the plausible bounds of performance. 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.

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

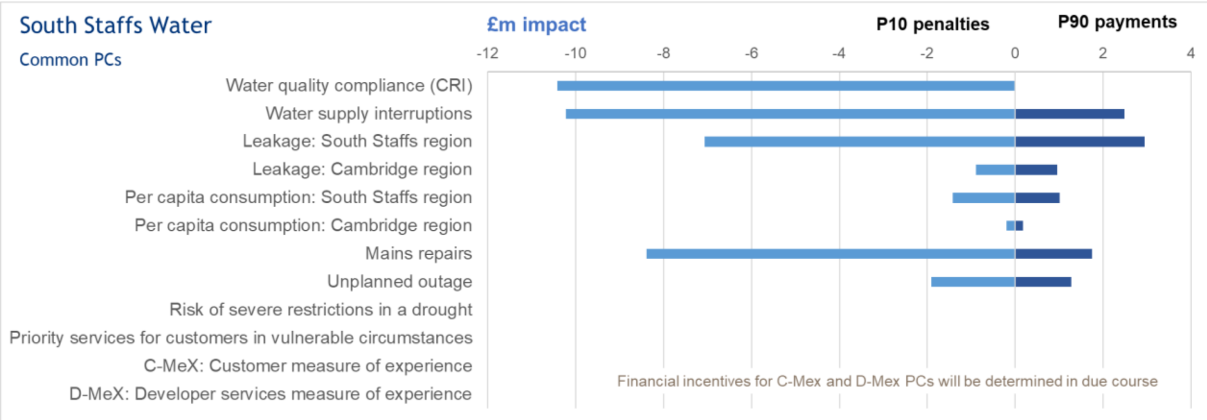


Figure 2.2: Projected P10 penalties and P90 payments for bespoke performance commitments over 2020-25 (£ million)

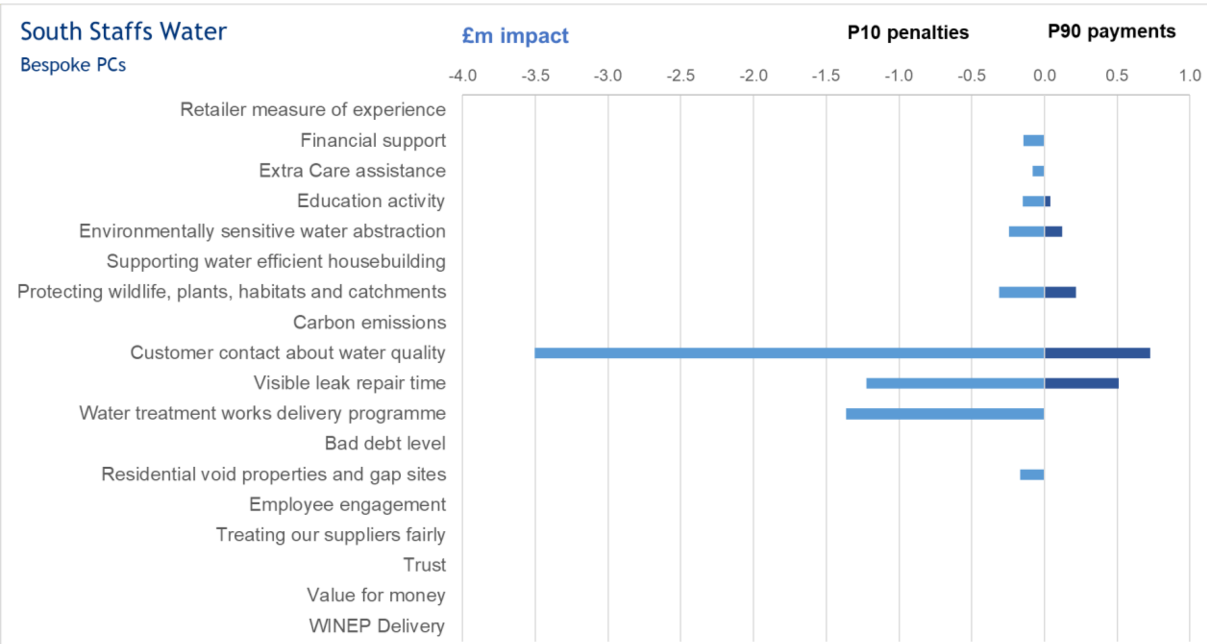


Table 2.4: Impact of draft determination interventions on RoRE range

	April 2019 business plan		Draft determination	
	% of 5 year regulatory equity		% of 5 year regulatory equity	
	P10	P90	P10	P90
South Staffs Water	-1.41	+1.35	-2.72	+0.43

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.

The company has accepted our standard sharing mechanism, 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 accept this proposal. We set out further detail of the mechanism in 'Delivering outcomes for customers policy appendix'. The company had originally designed all their outcome delivery incentives as end-of-period. We are intervening to change them to in-period, so that improvements or deterioration in company performance are more rapidly reflected in customer bills.

In our PR19 methodology, we decided to replace the current Service Incentive Mechanism (SIM) with two new mechanisms to incentivise companies to provide a great 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 be operational from April 2020. We set out further details on C-MeX and D-MeX in the 'Delivering outcomes for customers policy appendix'. We will publish our decisions on C-MeX and D-MeX incentive designs for 2020-25 as part of the final determinations in December.

We will finalise the company's performance commitments and outcome delivery incentives in the light of representations on this draft determination, so that these can be reflected as appropriate in the company's final determination to be published in December.

2.3 Linking outcomes to resilience

During the initial assessment of plans, we were concerned that companies' plans lacked a clear line of sight between the risks to resilience identified, the proposed mitigations presented in the plan to tackle these risks, and how these mitigation plans were reflected as service improvements in the form of stretching performance commitments. In this context, we are intervening to ensure South Staffs Water's asset health challenges are reflected in its outcomes and performance commitments, particularly in relation to the incentives attached to mains bursts, unplanned outage and the timely delivery of its water treatment works programme.

Our initial assessment of plans also noted that while South Staffs Water provided some visibility of risks to resilience and the management measures available, it provided insufficient evidence regarding the risk prioritisation and assessment process used. Overall, the company provided insufficient evidence to demonstrate the benefit that specific investments have in mitigating quantified levels of risk (and/or in increasing system resilience) and supporting stable or improved commitment targets. We expect companies to address this and other issues associated with the way they integrate resilience across their business in the action plans that will be submitted by 22 August 2019 and in their responses to the draft determinations in relation to specific investment proposals. We will take into account the quality of companies' response in our final determinations.

3 Cost allowances

We set out in our PR19 methodology that we expect company business plans to show a step change in efficiency. In its April 2019 business plan, South Staffs Water requests total expenditure levels that are 24% higher than it has incurred historically, although we recognise the company has reduced its costs relative to its September 2018 business plan. We find in particular that the proposed network plus control costs are significantly greater than our view of efficient costs. Our allowance for base costs is in line with the company's historical expenditure levels.

For enhancement expenditure we challenge the scope of work where the evidence provided to support solution options was lacking, and the efficient delivery of programmes. In particular, we challenge the need for an additional cost allowance to manage leakage in the water network plus programme. We are supportive of companies being ambitious in this area but consider that our outcomes mechanism is a more appropriate way of remunerating companies for high performance.

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 Staffs Water – Cost efficiency draft determination appendix' we provide more detailed information on our cost challenge for enhancement expenditure, our allowance for cost adjustment claims and transitional expenditure and how we will deal with the uncertainty in Water Industry National Environment Programme (WINEP).

3.1 Wholesale total expenditure

Table 3.1 shows the totex allowances by year and by wholesale price control for the period 2020-25. We have phased our allowed totex over 2020-25 using the company business plan totex profile.

Table 3.1: Totex[1] (excluding pension deficit recovery) 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 view - total
Water Resources	11.4	9.8	9.3	9.4	9.8	49.6	54.7
Water network plus	104.1	107.2	107.1	81.6	83.5	483.5	550.3
Total	**115.5**	**117.0**	**116.4**	**91.0**	**93.3**	**533.2**	**605.0**

1 Totex includes all costs except pension deficit recovery costs. This includes third party costs, operating lease adjustments, allowances related to the development of strategic regional water resource solutions and costs that are assumed to be recovered through grants and contributions.

Table 3.2 sets out the build-up of our totex allowance from base and enhancement costs. Base expenditure refers to routine, year on year costs, which companies incur in the normal running of their business. Enhancement expenditure refers to investment for the purpose of enhancing the capacity or quality of service beyond base level.

For draft determinations, we have changed the scope of costs included under base expenditure compared to the initial assessment of plans. Our base costs now include costs associated with the connection of new developments (ie new developments and new connection costs) and costs for addressing low pressure.

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

	Our cost allowance			Company view
	Water resources	Water network plus	Total	Company view – total
Base expenditure	42.4	386.6	429.0	463.6
Enhancement expenditure	7.2	90.0	97.2	134.4
Third party costs	0.0	7.0	7.0	7.0
Total – excluding pension deficit recovery	**49.6**	**483.5**	**533.2**	**605.0**
Pensions deficit recovery costs	0.8	8.8	9.7	0.4
Total	**50.4**	**492.4**	**542.8**	**605.4**

1. We display base costs under the new definition. Company business plan base costs exclude enhancement opex.
2. We are displaying pension deficit recovery costs separately as they are not included in the calculation for PAYG (see section 4).
3. Table 3.2 does not include operating lease adjustments, allowances related to the development of strategic regional water resource solutions. Any ex-ante cost sharing adjustments and costs that are assumed to be recovered through grants and contributions are also excluded. This is to allow a simpler comparison with base and enhancement costs. Table 3.6 sets out a reconciliation of inclusions and exclusions in totex for cost sharing and for the financial model.
4. The company view of pension deficit recovery costs is the full cost, not just the cost the company expects to include within price controls.

3.2 Base expenditure

Table 3.3 shows our challenge to company proposed base expenditure. We distinguish between ‘modelled base costs’ and ‘unmodelled base costs’. We challenge modelled based costs based on comparative assessment (using econometric models). Our efficiency challenge is based on cost performance within the sector as well as evidence from the wider economy.

Unmodelled base costs include business rates; abstraction charges and costs to meet the Traffic Management Act where applicable. Our assessment of these costs sits outside of our econometric models and we explain our approach in ‘Securing cost efficiency technical appendix’.

Table 3.3: Base totex expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price Control	Company business plan - base cost	Modelled base costs efficiency adjustment	Unmodelled base costs adjustment	Base cost allowance
Water Resources	43.0	-0.6	0.0	42.4
Water Network plus	420.6	-33.8	-0.2	386.6
Total	463.6	-34.4	-0.2	429.0

Note: Base costs include operating and maintenance costs as well as new development, new connections and addressing low pressure costs. Company business plan base costs exclude enhancement opex.

3.3 Enhancement expenditure

Table 3.4 summarises our allowances for enhancement expenditure.

Our draft determination allows South Staffs Water £97 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £63 million to improve resilience at Hampton Loade and Seedy Mill water treatment works which will improve taste odour and colour of customers' water; and
- £11 million to address the impacts of deteriorating raw water quality.

However, the most material areas of enhancement cost challenge for South Staffs Water are in resilience, addressing deteriorating raw water quality, eels regulations, improving taste, odour and colour, and leakage reduction.

Resilience

For resilience, the draft determination allowance is lower than the allowance we indicated at the initial assessment of plans. This reflects our assessment of the company's proposed investments against our refined criteria for assessing investment in resilience, focusing investment on mitigating low probability/high consequence risks. We explain our criteria in 'Securing cost efficiency technical appendix'. We do not allow enhancement costs for the proposed investments in 'network resilience' and 'borehole installation' because the company provides insufficient evidence of the specific cause of failure and how the company demonstrates the risk of such service failure in terms of probability and consequence. Furthermore there is insufficient evidence that mitigating against the failures and their consequences is beyond the company's management control. We invite South Staffs Water to consider our assessment and present further evidence in response to draft determinations.

Raw water deterioration

We assess the raw water deterioration enhancement case at scheme level. We find insufficient evidence of the reasons the company used to eliminate scheme options and continue to challenge these costs, allowing around two thirds of the costs the company proposes.

Eels regulations

We deep dive the eels regulations proposals. We conclude that the additional information provided increases, rather than addresses, our concerns at initial assessment of plans and continue to challenge these costs, allowing £1m less than the company proposes.

Improving water taste odour and colour

For taste, odour and colour improvements the company sets out a good case for its need to invest in its two major treatment works, Hampton Loade and Seedy Mill, to meet regulatory and customer expectations. Its choice of option and costs are developed using robust processes. However, we consider there is an implicit allowance for maintenance of the two sites in our modelled base allowance although we accept that only a proportion of the potential implicit allowance is applicable, and we adjust the costs we are allowing as a result. We allow £63m for the company to improve taste odour and colour at its major treatment sites.

Leakage

For leakage our expectation for base service levels is that an efficient company should achieve industry forecast upper quartile performance by 2024-25 in both normalised measures (per property and per kilometre of main). This performance is funded through the base allowance. We allow enhancement costs only where a company's performance commitment goes beyond the forecast upper quartile threshold. As this is not achieved by South Staffs Water, we do not allow the requested funding under enhancement. Companies are able to earn outperformance payments if they deliver leakage reductions beyond their stretching performance commitment levels.

'South Staffs Water - Cost efficiency draft determination appendix' sets out in more detail the cost allowances by investment area for each price control, and we give full details in our published models.

Table 3.4: Enhancement totex expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Service	Company requested totex	Scope and efficiency adjustment	Our allowance
Water Resources	10.8	-3.6	7.2
Water Network plus	123.6	-33.6	90.0
Total	134.4	-37.2	97.2

3.4 Cost sharing

When a company overruns its totex allowance, the additional cost incurred above our allowance will be shared between its investors and customers. When a company spends less than its totex allowance, it will share the benefits with customers.

For the draft determinations we calculate each company's cost sharing rates based on the ratio of the company's view of costs in its September 2018 business plan relative to our view of efficient costs. For the final determinations we propose to calculate the company's view of costs based on a 50% weight on the company's final cost proposals in its representation to the draft determination and 50% weight on the September 2018 business plan. We explain our approach to calculating cost sharing rates in the 'Securing cost efficiency technical appendix'.

Table 3.5: Totex cost sharing for cost performance for 2020-25, %

	Water resources	Network plus - water
Cost sharing rate – outperformance	37.9%	37.9%
Cost sharing rate – underperformance	62.1%	62.1%

Table 3.6 sets out the costs that are subject to cost sharing. We apply cost sharing to net totex. Net totex excludes grants and contributions, costs of operating leases, strategic regional water resources development costs, third party costs and pension deficit recovery cost.

We adjust allowed costs 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 have followed the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. South Staffs Water does not propose any adjustment.

Table 3.6: Totex subject to cost sharing rates – 2020-25, £ million[1]

	Water resources	Network plus – water	Company view
Gross totex (excluding third party costs)	49.6	476.6	605.0
Grants and contributions	0.0	-40.2	-84.0
Operating leases adjustment	0.0	0.0	0.0
Net totex (subject to cost sharing)	**49.6**	**436.3**	**521.0**
Strategic regional water resource solutions[2]	0.0	0.0	0.0
Third party costs	0.0	7.0	7.0
Ex-ante cost sharing adjustment	0.0	0.0	0.0
Net totex (for financial model)	**49.6**	**443.3**	**528.0**

[1] Table 3.6 does not include pension deficit repair expenditure, as this is not included in cost sharing.
[2] The standard totex cost sharing does not apply to strategic regional water resource solution expenditure, see 'Strategic regional water resources solution appendix' for more details.

3.5 Transition expenditure

South Staffs Water does not request any expenditure under the transition programme.

3.6 Residential retail

We determine the residential retail control from the expenditure set out in Table 3.7, using an econometric modelling approach to set our allowance. The residential retail draft determination does not include any of our allowed pension deficit recovery costs. These costs have been wholly allocated to wholesale controls.

Table 3.7: Expenditure, residential retail, 2020-25 (£ million, nominal)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail, allowed costs	12.5	12.5	12.5	12.5	12.5	62.3
Company view	11.7	11.9	11.8	12.0	12.1	59.5

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.

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

There is sufficient evidence that there are no projects suitable for a direct procurement for customers process within South Staffs Water's proposed plan. We expect South Staffs Water to consider direct procurement for customers for the Hampton Loade and Seedy Mill water treatment works schemes to ensure delivery is via the most efficient route, and to re-assess delivery via a direct procurement for customers process if there are significant changes to project scope, to ensure that customers continue to receive the best value.

4 Calculation of allowed revenue

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.

Wholesale controls

For the wholesale controls (that is water resources and water network plus), allowed revenue is calculated based on the following elements, not all elements are applicable to all wholesale controls as set out in Table 4.1.

- Pay as you go (PAYG) – this reflects the allocation of our efficient totex baseline to costs that are recovered from revenue in 2020-25. The proportion of totex not recovered from PAYG is added to the regulatory capital value (RCV) which is recovered over a longer period of time.
- Allowed return on capital – this is calculated based on our assessment of the cost of capital multiplied by the average RCV for each year.
- RCV run-off – this reflects the amount of RCV that is amortised from the RCV in the period of the price control.
- PR14 reconciliations – this reflects the application of out/underperformance payments from PR14 through revenue adjustments in 2020-25.
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the draft determination.
- Grants and contributions – this represents revenue that we expect to be received from developers and other customers in respect of work undertaken by companies to service new developments. It will include income from connection charges and infrastructure charges. This does not necessarily agree to the total grants and contributions deducted from totex, as only the income relating to the price control is included here.

- 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. 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.
- 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 Staffs 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 cost of capital in section 4.2, the revenue adjustments for PR14 reconciliations in section 4.3, and other elements of allowed revenue in section 4.4.

Table 4.1: Calculation of allowed revenue (£ million)

	Water resources	Water network plus	Total	Company view - total
Pay as you go	33.3	259.9	293.2	328.8
RCV run-off	9.8	131.5	141.4	141.3
Return on capital	2.6	54.0	56.6	61.2
Revenue adjustments for PR14 reconciliations	0.0	-14.3	-14.3	1.5
Tax	0.1	0.1	0.2	3.0
Grants and contributions (price control)	0.0	38.1	38.1	58.9
Deduct non-price control income	0.0	-9.2	-9.2	-9.2
Revenue re-profiling	0.0	-0.1	-0.1	0.0
Final allowed revenues	45.9	460.1	505.9	585.6

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the ‘South Staffs Water - Allowed revenue appendix’ in Tables 1.1 to Table 1.2.

Residential retail control

For the residential retail control, allowed revenue is calculated as:

- Retail cost to serve – this reflects our efficient view of costs per customer for the retail business.
- Net margin on wholesale and retail activities – this is calculated based on the wholesale revenue applicable to residential retail customers, plus the retail cost to serve, with a net margin applied. Net margins are calculated excluding any adjustments to residential retail (see Table 4.2 below) – the full calculation is set out in our financial models.

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

Allowed revenue for the residential retail control is set on a nominal basis and therefore we present the make-up of the allowed revenue in nominal prices in Table 4.2.

Table 4.2: Retail margins (nominal price base)

	2020-25	Company view 2020-25
Total wholesale revenue - nominal (£ million)	514.8	585.3
Proportion of wholesale revenue allocated to residential (%)	78.24%	78.24%
Residential retail costs (£ million)	62.3	59.5
Total retail costs (£ million)	465.1	517.4
Residential retail net margin (%)	1.00%	1.00%
Residential retail net margin (£ million)	4.7	4.8
Residential retail adjustments (£ million)	3.2	4.1
Residential retail revenue (£ million)	70.3	67.6

Note: retail revenue is the sum of the net margin, retail costs, and adjustments. Company view may not sum as this may include other adjustments.
Note: the proportion of wholesale revenue allocated to residential customers is provided by the company in the business plan tables. This is provided for each wholesale control separately, so although we have used the same proportions for each control as the company, our interventions on costs in each control mean that the combined proportion is slightly different.

We set out the calculation of residential retail revenue on an annual basis in the 'South Staffs Water - Allowed revenue appendix' in Table 1.3.

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

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

To determine the allowed revenue, the PAYG rate is applied to the totex allowance for each wholesale control for each year of the price control. The proportion of the totex allowance that is not recovered in PAYG is added to the RCV and recovered from customers in future periods.

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

PAYG

We calculate total PAYG totex for each year of each wholesale price control based on the totex allowance for each year multiplied by the relevant PAYG rate for that year. To this we add allowed pension deficit recovery costs to derive total PAYG revenue.

We summarise in Table 4.3 the average PAYG rates across 2020-25 for each wholesale control, and the calculation of total PAYG revenue. The PAYG rates shown in the table are a weighted average across the five years 2020-25, the annual PAYG revenue and PAYG rates for each wholesale control are shown in the 'South Staffs Water - Allowed revenue appendix', Tables 2.1 to 2.2.

To PAYG totex we add the allowed costs for pension deficit recovery set out in Table 3.2 to derive total amount to be recovered in 2020-25 for each price control.

Table 4.3: PAYG allowances for each wholesale control (5 year)

	Water resources	Water network plus	Total	Company view - Total
Totex allowance (£ million)	49.6	443.3	492.9	535.8
Draft determination PAYG rate (%)	65.5%	56.6%	57.5%	61.3%
Pay as you go totex (£ million)	32.5	251.1	283.6	328.3
Pension deficit recovery cost (£ million)	0.8	8.8	9.7	0.5
Total pay as you go (£ million)	33.3	259.9	293.2	328.8
Company plan PAYG rate (%)	68.9%	60.4%		61.3%

South Staffs Water's approach to PAYG rates is to recover in each year an amount equivalent to operating costs. We accept the approach taken by the company and apply a technical intervention to amend the PAYG rates proposed in the business plan to reflect our view of the mix of operating and capital expenditure following our totex interventions compared with the business plan.

South Staffs Water proposes an average 3% increase to PAYG rates in its revised business plan to solve a financeability constraint it has identified on the basis of the notional company structure. The financeability constraint arises from South Staffs Water's aim to maintain an adjusted cash interest cover ratio of at least 1.5x throughout 2020-25. This ratio falls during the period primarily due to the bill profile proposed by the company, which it aims to keep stable in nominal terms resulting in declining revenues in real terms. South Staffs Water states that the consequence of the flat nominal bills is a potential step change in bills in the following price review period and sets out that the use of PAYG levers to solve the financeability constraint provides for the management of the transition of bills for 2020-25 to 2025-30. The increase to PAYG rates reduces the increase in bills in the following period under the company's inflation assumption. However, it does not fully mitigate the potential for large reconciliation adjustments at PR24. South Staffs Water's further sets out that it will increase nominal bills during 2020-25 if it forecasts the step in bills will be greater than £3 in 2025-26. We do not consider this is not consistent with the company's proposal to maintain flat nominal bills.

As set out in section 6.1, the company does not provide sufficient evidence that the long term bill profile is consistent with the preferences of customers and therefore that the increase to PAYG rates to maintain flat nominal bills is appropriate. We set out our assessment of notional financeability in section 5.4 and we conclude an increase in PAYG rates is not required on the basis of financeability and is not supported by compelling evidence that the proposed approach is in the best interests of customers. We are intervening to remove the adjustments to PAYG rates in our draft determination.

We set out how we apply the technical intervention in 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our draft determinations.

Opening RCV adjustments

As part of the business plan South Staffs Water proposed allocations of the RCV for Water Resources price control based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale control and the water resources control in accordance with the proportions proposed by South Staffs 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 have followed the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. South Staffs Water did not propose any adjustment.

Table 4.4: Opening RCV, 1 April 2020 (£ million)

	Water resources	Water network plus
RCV – 31 March 2020	380.1	
% of RCV allocated by control	3.67%	96.33%
RCV – 31 March 2020	13.9	366.2
Midnight adjustments to RCV	-0.3	-7.8
Midnight adjustments relating to operating leases	-	-
Opening RCV – 1 April 2020 (before fast-track reward)	13.6	358.4

Return on capital

Companies are allowed a return on the RCV, equal to the Weighted Average Cost of Capital (WACC).

Our PR19 methodology set out an ‘early view’ cost of capital for all wholesale controls. South Staffs Water’s business plan incorporates the early view cost of capital for the wholesale price controls of 3.30% - CPIH deflated (2.30% - RPI deflated). We have updated our view of the cost of capital for the wholesale price controls to 3.08% – CPIH deflated (2.08% – RPI deflated). We set out the basis for the updated view in the ‘Cost of capital technical appendix’. We have used our updated cost of capital in this draft determination.

The PR19 methodology confirmed we will transition to CPIH as the primary inflation rate 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 4.5 and Table 4.6 set out the opening and closing balance for each component of RCV.

The PR19 methodology confirmed our protection of the value of the RCV as at 31 March 2020 across each of the wholesale price controls. Totex that is added to the RCV from 1 April 2020 is stated as ‘post 2020 investment’.

In determining the ‘return on capital’ revenue building block, we apply the relevant deflated cost of capital to the average RCV for the year for each component (RPI inflated, CPIH inflated and post 2020 investment). This results in a return on capital for each wholesale control over the period 2015-20 as set out in Table 4.7.

Table 4.5: Opening RCV by wholesale control for each component of RCV, 1 April 2020 (£ million)

	Water resources	Water network plus	Total
RPI inflated RCV	6.8	179.2	186.0
CPIH inflated RCV	6.8	179.2	186.0
Other adjustments	-	-	-
Total RCV	13.6	358.4	372.0

Table 4.6: Closing RCV by wholesale control for each component of RCV, 31 March 2025 (£ million)

	Water resources	Water network plus	Total
RPI inflated RCV	3.2	124.4	127.5
CPIH inflated RCV	2.9	135.4	138.4
Post 2020 investment	15.1	166.4	181.5
Other adjustments	-	-	-
Total RCV	21.2	426.2	447.4

Table 4.7: Return on capital by wholesale control for each component of RCV, 2020-25 (£ million)

	Water resources	Water network plus	Total
RPI inflated RCV	0.5	15.7	16.2
CPIH inflated RCV	0.7	24.0	24.8
Post 2020 investment	1.3	14.3	15.7
Other adjustments	-	-	-
Total return on capital	2.6	54.0	56.6
Company view – total return on capital	2.8	58.5	61.2

Note: Total 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 return on capital for each year of the price control for each wholesale control are shown in the 'South Staffs Water - Allowed revenue appendix' in Tables 3.1 to 3.8 and 4.1 to 4.2.

RCV run-off

RCV run-off is the proportion of the RCV which is recovered in the 2020-25 period. Companies are able to propose different run-off rates for RPI inflated and CPIH inflated RCV and also for the water resources control for post 1 April 2020 investment. Table 4.8 sets out the resultant RCV run-off revenue for each component of RCV for each wholesale control.

Table 4.8: RCV run-off on the RCV (5 year) (£ million)

	Water resources	Water network plus	Total
CPIH inflated RCV	3.9	43.7	47.7
RPI inflated RCV	3.9	62.0	65.9
Post 2020 investment	2.0	25.8	27.8
Total RCV run-off	9.8	131.5	141.4
Company view – total RCV run-off	9.8	131.5	141.3

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).

South Staffs Water's RCV run-off rates recover an amount equivalent to current cost depreciation within each wholesale control. We accept South Staffs Water's RCV run-off rates for the draft determination. However, the interventions to allowed totex changes the post-2020 investment added to RCV and therefore the total RCV run-off. Table 4.9 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 determination.

Table 4.9: RCV run-off rates for each wholesale control (5 year)

	Water resources	Water network plus
Original company plan (%)	10.05%	6.36%
Draft determination (%)	9.97%	6.36%

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.

Where there are different RCV run-off rates for post-2020 investment RCV, or CPIH inflated RCV for the water network plus control, compared to other elements of RCV, interventions to allowed totex and to PAYG rates may result in average RCV run-off rates varying between the company plan and the draft determination. The annual rates for each wholesale control are set out in the 'South Staffs Water - Allowed revenue appendix' in Table 5.1 to Table 5.2

4.3 PR14 reconciliations

In PR14, we set mechanisms to incentivise companies to do the right thing for their customers. These financial incentives cover cost efficiency, outcomes performance, revenue forecasting (wholesale and retail), customer service (the service incentive mechanism), water trading and land sales. It is important to reconcile the financial impacts of these mechanisms in PR19 to ensure that customers only pay for the service the company delivers.

We are also applying adjustments to reflect performance in the final year of the 2010 to 2015 period, which could not be fully taken into account in PR14. 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 Staffs Water - Accounting for past delivery actions and interventions' provides a detailed explanation of all policy interventions we are making in the models. Table 4.10 summarises our interventions. Table 4.11 sets out the resulting adjustments to revenue and the RCV. The 'South Staffs 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 4.4.

We are publishing the results of the reconciliation of the service incentive mechanism for all companies alongside the draft determinations for slow track and significant scrutiny companies in the 'Accounting for past delivery technical appendix'.

For outcome delivery incentives, the information we have used 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 planned 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 will designate 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 would not expect a significant impact on bills. If, contrary to expectations the bill impact were to be more significant, we would 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 have used forecast information for 2018-19 and 2019-20 to reconcile these outcome delivery incentives. For the avoidance of doubt, no application is required in 2019 for in period determinations.

Table 4.10: Reconciliation of PR14 incentives, interventions

Incentive	Intervention(s)
Outcome delivery incentives	We are intervening to adjust the 2015-16 and 2017-18 underperformance payments for performance commitment 1.2 (acceptability of water to customers) so that they are calculated using actual performance levels to two decimal places as confirmed in the 'PR14 final determination company-specific appendix'. This minor intervention decreases the total net performance payment from £3.352 million to £3.341 million.
Residential retail revenue	We are intervening to round the company's modification factor figures to 2 decimal places to ensure consistency with the 'PR14 reconciliation rulebook'. We are including a figure of 3.74% for the 'Materiality threshold for financing adjustment - Discount Rate' in line with the 'PR14 reconciliation rulebook'. Overall, our minor interventions do not result in any changes to the total residential retail revenue payment at the end of the 2015-20 period which remains at £1.002 million.
Wholesale revenue forecasting incentive mechanism	We are intervening to adjust the aggregate value of the revenue claim from £18.9 million to £6.004 million (outturn prices) in respect of higher grants and contributions revenue than included in the 2014 price review final determination. We have accepted the elements of the claim that are driven by the volume of new connections. We have not accepted the elements of the claim where the variance relates to cost or type of new connection as these are not within the scope of the adjustment as set out at PR14, which related to the demand for new connections only. We have not accepted the element of the claim relating to main requisition charges, which is due to errors the company made in completing its PR14 business plan, as these are also outside the scope of the adjustment mechanism. Our intervention increases the total WRFIM adjustment at the end of the 2015-20 period from - £1.883 million to - £16.891 million.
Totex	No interventions required.
Land sales	No interventions required.
Service incentive mechanism	We are intervening to set South Staffs Water's service incentive mechanism adjustment to + 2.22% of household retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to £1.726 million in total revenue over the period. This decreases revenue relative to the company's estimate of the mechanism's impact.
PR09 blind year adjustments	No interventions required.

Table 4.11: Reconciliation of PR14 incentives, 2020-25 (£ million, 2017-18 prices)

Incentive	RCV adjustments		Revenue adjustments	
	Company view	Ofwat view	Company view	Ofwat view
Outcome delivery incentives	0.0	0.0	3.4	3.3
Residential retail revenue	N/A	N/A	1.0	1.0
Wholesale revenue forecasting incentive mechanism	N/A	N/A	-1.9	-16.9
Totex	-0.1	-0.2	-0.4	-0.4
Land sales	-0.1	0.0	N/A	N/A
Service incentive mechanism	N/A	N/A	2.4	1.7
PR09 blind year adjustments	-7.9	-7.9	-0.1	-0.1
Water trading	N/A	N/A	0.0	0.0
Total	-8.1	-8.1	4.5	-11.3
Total post profiling	N/A	N/A	4.8	-12.0

Note: 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.

These reconciliations are based on data from the 1 April company submissions. We will update these reconciliations to reflect the July data submissions for the final determinations.

4.4 Other allowed revenue

Other components of allowed revenue are:

- 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 will include income from connection charges and infrastructure charges.

- 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 4.12: Calculation of other allowed revenue (£ million)

	Water resources	Water network plus	Total	Company view - total
Tax	0.1	0.1	0.2	3.0
Grants and contributions (price control)	0.0	38.1	38.1	58.9
Deduct non-price control income	0.0	-9.2	-9.2	-9.2

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 UK corporation tax rates and associated reliefs and allowances.

South Staffs Water provided information in data tables relevant to the calculation of the expected tax charge. The information has been updated as part of the resubmission of various data tables to take account of the recent changes to capital allowances. We have accepted the information provided by the company and applied this to the draft determination.

Our financial model calculates a lower level of taxable profits than the company view, so the resulting tax allowance is lower. This difference is mostly driven by the lower final allowed revenues calculated by the financial model, which are a result of our interventions compared to the company view.

Our interventions in other areas may impact on forecast levels of capital expenditure and in the area of new connections our assumed recovery rates may differ from what South Staffs Water assumes in the business plan. The resulting impact on allowances used for the calculation of taxation has not been reflected. Where these changes result in significantly different inputs for capital allowances or tax deductions, we expect South Staffs Water to identify this as part of its representations on the draft determination.

Table 4.13: Calculation of other allowed revenue (£ million) - Tax

	Water resources	Water network plus	Total	Company view - total
Tax	0.1	0.1	0.2	3.0

Grants and contributions (price control)

Companies receive grants and contributions from developers towards the costs of ‘new developments’, expenditure to reinforce the network, and ‘new connections’, expenditure to connect a property, for example the meter and connection pipe. We calculate the grants and contributions receivable by applying a recovery rate to our view of new developments and new connections expenditure. This ensures that developers pay a fair share towards costs to connect new properties. We use this calculation of grants and contributions receivable from developers to ensure that the amounts billed to water customers correctly reflect only that share of any new development spend which should be borne by them.

The recovery rates are calculated as follows;

- For water new developments we use the rate implied by the South Staffs Water business plan which is 93.9%; and
- For water new connections we use a rate of 100% based on our understanding of historical practice in the industry and is broadly supported by company business plans.

Table 4.14 shows our assumed amounts of grants and contributions. Our view of new developments and new connections expenditure is lower than South Staffs Water’s forecast. The reasons behind the differences in our view of ‘Base expenditure’ are set out above in the ‘Cost allowances’ section. This gives a lower view of grants and contributions than the company forecast. We have included the company forecast contribution of £10.5m from Severn Trent Water in respect of the expenditure at Hampton Loade treatment works.

For diversions activities, where companies move their assets to make way for new infrastructure, we use the company view of the associated income and assume that this represents 100% of the costs. In modelling our draft determinations we assume that all diversions income is inside the price control. For the final determinations we consider that we should make a distinction between diversions that are inside or outside the scope of section 185 of the Water Industry Act 1991. Works that are outside the scope of section 185 are, for example, works under the New Roads and

Street Works Act 1991 or those associated with High Speed 2. We are yet to have sufficient data to be able to distinguish section 185 diversions from non-section 185 diversions. For the final determination we will assume diversions expenditure is inside the price control unless it relates to non-section 185 diversions. Where companies forecast diversions works outside of section 185 then they should provide details of the income relating to this, on an annual basis, in the data request that accompanies the draft determination. This should be returned with the representations to the draft determination.

Table 4.14: Calculation of other allowed revenue (£ million) – Grants and contributions

	Water resources	Water network plus	Total	Company view - total
Grants and contributions	0.0	38.1	38.1	58.9

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. 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 draft determination.

Table 4.15: Calculation of other allowed revenue (£ million) – Non-price control income

	Water resources	Water network plus	Total	Company view - total
Non-price control income	0.0	-9.2	-9.2	-9.2

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

Uncertainty mechanisms

The PR19 methodology makes limited provision for companies to propose bespoke uncertainty mechanisms. South Staffs Water has not proposed any uncertainty mechanisms in its business plan.

5 Assurance, returns and financeability

This section sets out the accountability the company's Board has demonstrated for delivering its plan, the accuracy and consistency of the information within the plan and company proposals for aligning the interests of company management and investors with its customers. We summarise South Staffs Water's response to our actions on securing confidence and assurance, including South Staffs Water's proposals in response to our 'Putting the sector in balance' position statement. We comment on the possible range of returns for the notional financial structure. We comment also on the financeability of the draft determination and any adjustments that we have made to the bill profile.

5.1 Assurance

The PR19 methodology set out that stakeholders should have confidence in the information presented in business plans. We set expectations that:

- the data and information presented in the plan must be subject to good assurance processes to ensure it is consistent and accurate; and
- a company's full Board should own, be accountable for and provide assurance of the business plan.

In the initial assessment of plans, we identified five actions in relation to data tables and financial model. South Staffs Water has satisfactorily responded to four of these actions as set out in its response to our actions on securing confidence and assurance. For the remaining required action, we require the company to provide further evidence to explain the assurance process it has taken to develop its tax forecasts.

If the company does not provide sufficient evidence in advance of the final determination, we will consider whether it is appropriate to make an adjustment to the tax allowance in the final determination.

We had no concerns with South Staffs Water's forward-looking Board assurance statements and therefore set no actions in the initial assessment of plans.

5.2 Putting the sector in balance

In July 2018 we published our 'Putting the sector in balance' position statement. The position statement set 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 their actual financial structures and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers[2];
- companies with high levels of gearing will 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.

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

Our assessment of South Staffs Water's proposals is in Table 5.1.

Table 5.1: Our assessment of South Staffs Water's proposals to balance the interests of customers

Issue	Our assessment
Gearing outperformance benefit sharing	South Staffs Water's regulatory gearing is expected be above 70% over 2020-25, based on the difference between their covenanted and regulatory gearing (c. 5%), and the company's forecast average level of covenanted gearing over this period (69%). South Staffs Water states it will adopt our default mechanism as detailed in the 'Putting the sector in balance' statement, subject to the adjustment that it would use its definition of covenanted gearing, which is lower than the definition of regulatory gearing. The company comments that regulatory gearing includes accounting adjustments that do not represent actual liabilities; it considers covenanted gearing to be more relevant as the figure used by its stakeholders. South Staffs Water's definition for gearing is specific to its own financing arrangements and is a matter for the company and its investors. South Staffs Water has not provided compelling evidence that its proposed alternative mechanism would deliver equivalent benefits for customers in the round. Further, South Staffs Water projects limited headroom in the financial ratios under its actual structure. While the company proposes some limited reduction in gearing through 2020-25 which may reduce risks to customers in the long term, we seek further assurance from the company about the levels of financial resilience it will achieve as a consequence of the interventions in its plan. We do not consider that applying the definition of gearing set out in its covenants is in the best interest of customers in the context of the limited levels of headroom. Therefore, we do not to accept South Staffs Water's sharing mechanism proposal.

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

<table>
<tr><th>Issue</th><th>Our assessment</th></tr>
<tr><td></td><td>We expect South Staffs Water to apply our default mechanism and to use the regulatory gearing number from its Annual Performance Report. If the company does not apply the default mechanism set out in the ‘Putting the sector in balance’ position statement, we intend to make an adjustment at PR24 to ensure benefits are adequately shared with customers.
We expect to set out how such an adjustment would apply in the PR19 reconciliation rulebook.</td></tr>
<tr><td>Voluntary sharing mechanisms</td><td>South Staffs Water has not proposed a voluntary sharing mechanism. However, it does provide a hardship fund to customers, which provides support for customers in one-off circumstances that make them financially vulnerable.</td></tr>
<tr><td>Dividend policy for 2020-25</td><td>South Staffs Water has committed to the expectations on dividend policy as set out in our ‘Putting the sector in balance’ position statement. In doing so it has indicated an average gross base dividend yield of 3.8% for 2020-25, through a query response (2.2% after netting off inter-company loan interest income) It has confirmed that when setting dividend payments, it will take into consideration its actual performance in relation to regulatory and customer targets (principally delivered through performance commitments).

The company has provided a clear Board commitment to publish detail on dividend policies in its Annual Performance Report and to signal changes to stakeholders; and a commitment to transparency about how its dividend policy takes account of obligations and commitments to customers when determining dividends.

However insufficient detail has been provided on which obligations or commitments to customers will be considered, the level of performance delivery used for the assessment and how it will affect dividend payments. We expect the company to be transparent in this area, 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.</td></tr>
<tr><td>Performance related executive pay policy for 2020-25</td><td>South Staffs Water states that it will align its performance related executive pay to the expectations we set out in our 'Putting the sector in balance’ position statement. For 2020-25 the company is proposing:
• an annual bonus based on one third customer service (including C-Mex, D-Mex and complaints), one third outcomes performance (including leakage, asset health, CRI and employee safety) and one third financial performance (including profit, cash generation, totex performance).
• a commitment to introduce a long term bonus, before April 2020, which although not yet designed will include key elements of customer service, outcome delivery incentives and financial performance.
• stretching targets that in most cases are on or close to the upper quartile performance for the industry. In addition maximum levels of executive variable pay should only be achieved in response to outperformance of targets that could be described as 'exceptional', defined as being outperformance against a regulatory / customer commitment.
• a commitment to publish the policy ahead of 1 April 2020 including the initial performance targets, and that the remuneration committee will manage the policy in line with these targets throughout 2020-25, reviewing them each year to ensure they remain appropriate and in line with customer expectations.</td></tr>
</table>

<table>
<tr><th>Issue</th><th>Our assessment</th></tr>
<tr><td></td><td>a commitment to full transparent reporting in the annual performance report, including any changes to the policy and the underlying reasons for the change.
We understand that there remain some details to be finalised, for example details of the underlying metrics and associated weightings in the annual bonus and the finalisation of the long term bonus. The policy demonstrates the company’s commitment to move in the direction of the expectations set out in ‘Putting the sector in balance’. We expect South Staffs Water to provide an update on this in response to its draft determination.
We expect South Staffs Water to demonstrate that its policy on performance related executive pay demonstrates a substantial link to stretching performance delivery for customers through 2020-25. We expect the company and its remuneration committee to ensure executives have stretching targets linked to performance delivery for customers and that any further updates to the policy for 2020-25 are transparently reported to stakeholders in its annual performance report. </td></tr>
<tr><td>Financial resilience of the company’s actual financial structure</td><td> In its revised business plan, South Staffs Water sets out that, after careful consideration of our assessment in the initial assessment of plans, it has made the decision to further strengthen financial resilience by reducing gearing. It expects gearing to remain below 70% under its definition of covenanted gearing, though gearing will remain above the threshold of 70% for the gearing outperformance mechanism under the definition of regulatory gearing. South Staffs Water says that, consistent with the company Board’s objective of maintaining a strong investment grade, it has targeted credit ratings of Baa1/BBB+ for both its notional and actual capital structures.
The company confirms in its revised Board assurance statement that its governance and assurance processes will meet long term resilience in the round. However, South Staffs Water’s business plan shows limited headroom on the basis of its actual financial structure and assumes financial ratios will improve in 2025-30 but comments in its plan that there is a risk the cost of capital could be lower at PR24. Its assessment does not take account of our interventions to South Staffs Water’s business plan, which includes, for example, our updated view of the cost of capital, our assessment of efficient costs, and our assessment of outcome delivery incentives. Each company is responsible for ensuring its capital and financial structure allows it to maintain financial resilience over the short and the long term and so we expect South Staffs Water to take account of these issues in its commentary on its long term financial resilience in response to our draft determination.
The company should provide further detail and Board assurance about its plans to maintain its long term financial resilience in the context of our draft determination, taking account of the reasonably foreseeable range of plausible outcomes of the final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the ‘Cost of capital technical appendix’.
In its future reporting, we expect South Staffs Water to apply suitably robust stress tests in its long term viability statements in 2020-25.
We will monitor the commitments and assurances the company has provided, in particular with respect to reduction of its gearing level. </td></tr>
</table>

5.3 Return on regulatory equity

The PR19 methodology sets out that we expect companies to demonstrate a clear understanding of risk to the delivery of their business plans and to explain and demonstrate how they manage and mitigate risk. We expected 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 P10/P90 confidence limit values[3].

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 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[4]. The proportion of RCV (and notional regulatory equity) that is linked to RPI or CPIH will vary 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.

Table 5.2 sets out the annual average RoRE ranges in South Staff Water's updated PR19 business plan submission, and the values in our draft determination. The base RoRE in our draft determination reflects our updated cost of equity. The RoRE ranges reflect our interventions outlined below, and other interventions we are making as part of our draft determination.

[3] 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.

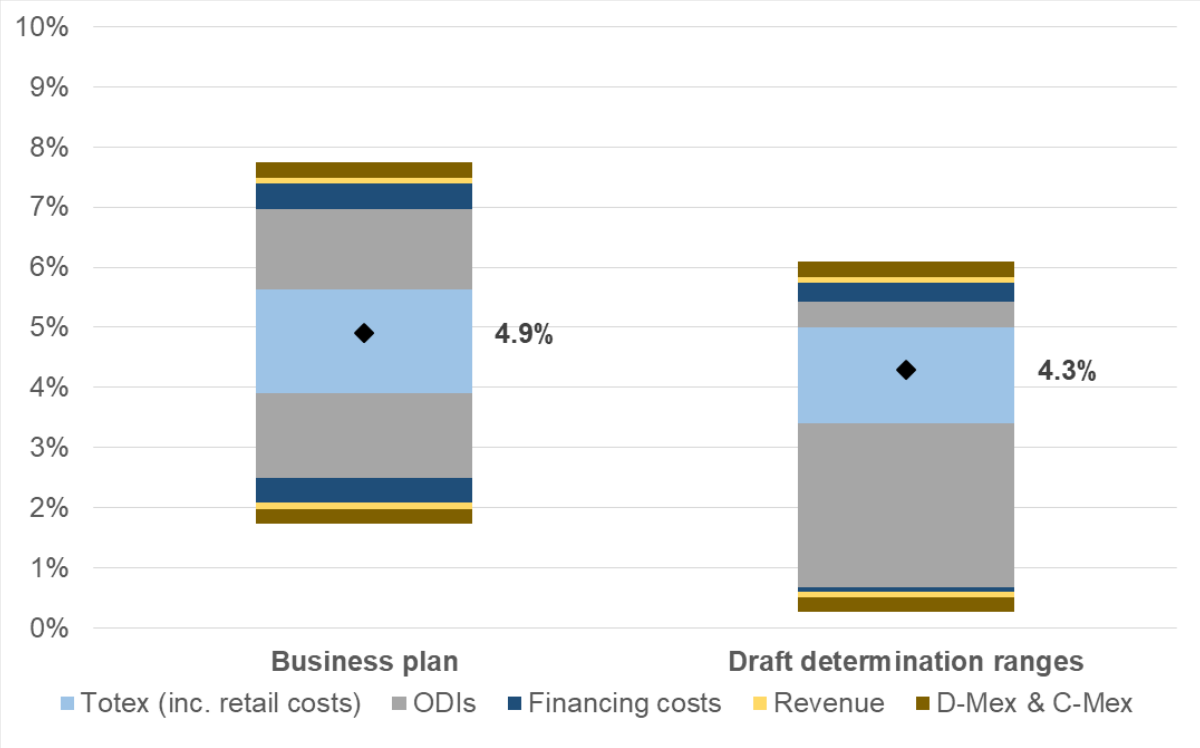
[4] RPI is the retail price index; CPIH is the consumer price index including owner-occupiers' housing costs; both are published by the Office for National Statistics.

Table 5.2: South Staffs Water RoRE ranges

	Updated Business plan (Apr 19)		Draft determination ranges reflecting our interventions	
Base RoRE	4.9%		4.3%	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-0.79%	0.39%	-0.78%	0.39%
Outcome delivery incentives[5]	-1.41%	1.35%	-2.72%	0.43%
Financing costs	-0.41%	0.41%	-0.07%	0.30%
Retail costs	-0.21%	0.32%	-0.21%	0.32%
D-Mex & C-Mex	-0.24%	0.26%	-0.23%	0.26%
Revenues (includes Retail)	-0.10%	0.10%	-0.10%	0.10%
Total	**-3.16%**	**2.83%**	**-4.11%**	**1.80%**

[5] For South Staffs Water we have used the company's September 18 submission values for outcome delivery incentives because its April 19 submission removed its view of covariance amongst performance commitments.

Figure 5.1: RoRE ranges



The draft determination risk ranges shown in Table 5.2 and Figure 5.1 reflect two interventions we are making with respect to values in South Staffs Water's revised business plan:

- For the draft determination we are intervening to reduce South Staffs 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. It is also consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt, and the company has not provided convincing evidence for a higher risk range. 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.
- We are intervening to align the RoRE risk ranges for outcome delivery incentives shown in Table 5.2, Figure 5.1, and in the PR19 financial model with the RoRE risk range values for outcome delivery incentives set out in section 2 (Outcomes). The revised values reflect our interventions on outcome delivery incentives under the Outcomes Framework which seek to take account of covariance of performance on individual outcome delivery incentives in the presentation of the overall outcome delivery incentive range.

In all other areas we have retained South Staff's Water's proposed RoRE range. There is a significantly negative skew overall, driven primarily by outcome delivery incentives. Our view is that an efficient company should be able to achieve the base equity return on the notional structure. We expect South Staffs Water to consider necessary revisions to its overall RoRE range in response to the draft determination.

5.4 Financeability

We interpret our financing duty as a duty to secure that an efficient company can finance the proper carrying out of its functions, in particular by securing reasonable returns on its capital. In coming to our determinations we assess whether allowed revenues, relative to efficient costs, are sufficient for a company to finance its investment on reasonable terms and to deliver activities in the long term, while protecting the interests of current and future customers.

Our PR19 methodology required companies to provide Board assurance that the business plan is financeable on both the notional and their actual capital structures. Our methodology required 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. South Staffs Water's Board has provided assurance that, based on the assumptions in its business plan, both notional and actual capital structures remain financeable in the long-term, and that key financial ratios are at a level that retain sufficient headroom to maintain an investment grade credit rating and ensure that resilience and customers' interests are maintained in the short and long term.

South Staffs Water identifies a financeability constraint on the basis of the notional company structure. The company proposes an increase to PAYG rates of on average 3% to solve the constraint. South Staffs Water targets an adjusted cash interest cover ratio of at least 1.5x for each year of the price review and proposes a bill profile that is flat in nominal terms throughout 2020-25 with limited increases thereafter. To achieve the bill profile in 2020-25 and the transition to bills in 2025-30, the company uses PAYG rates to bring forward revenue and profile this across the period. We set out in section 4.2 how the increase in PAYG rates may not alleviate bill increases in 2020-25 or an increase greater than customers support in 2025-26. Without bringing forward revenue from future periods, the adjusted cash interest cover ratio would be below its stated target in later years. As set out in section 6.1, we are not convinced the company has provided sufficient evidence that the chosen bill profile is supported by its customer engagement and therefore, along with our assessment of financeability (which includes a PAYG adjustment to achieve its target nominal bill profile), we do not consider that the proposed increase to PAYG rates in 2020-25 to achieve the bill profile is appropriate. We are intervening to remove the adjustments to PAYG rates in our draft determination as set out in section 4.2.

We consider that companies and their shareholders should bear the risk of their capital structure and financing choices, not customers. Therefore, we have focused on whether our draft determination is financeable based on the notional capital structure that underpins our cost of capital using our own financial model.

Our financeability assessment uses a suite of financial metrics based on those used in the financial markets and by the credit rating agencies. We initially assess notional financeability excluding South Staffs Water's proposed increase to PAYG rates. Without the PAYG increase, and based on the financial ratios from the financial model alongside evidence in the business plan, we consider that South Staffs Water's draft determination is financeable for the notional structure. Therefore, we do not consider the proposed increase to PAYG is necessary and we are intervening to remove this for our draft determinations.

The results for key financial ratios after our intervention to reduce PAYG rates are set out below. Key financial ratios for the notional company structure in our draft determination are broadly in line compared to the ratios set out by South Staffs Water in its business plan.

Table 5.3: Financial ratios – notional structure before reconciliation adjustments (5 year average)

	Business plan	Draft determinations
Gearing	61.06%	61.46%
Interest cover	4.90	4.90
Adjusted cash interest cover ratio (ACICR)	1.85	1.66
Funds from operations (FFO)/Net debt	13.95%	13.04%
Dividend cover	2.74	1.34
Retained cash flow (RCF)/Net debt	12.79%	11.17%
Return on capital employed (RoCE)	4.75%	4.16%

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.

As set out in section 4 we have amended PAYG rates to reflect our view of efficient totex and therefore the mix of operating and capital expenditure.

We are not intervening to amend RCV run-off rates.

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

	PAYG	RCV run-off	RCV growth
Company plan	61.3%	6.52%	19.75%
Draft determinations	57.5%	6.52%	20.26%

South Staffs Water is responsible for the financeability and long term financial resilience of its actual structure. We comment further on the financial resilience of the company's actual structure in Table 5.1.

We expect companies to provide further Board assurance 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 'Cost of capital technical appendix'.

6 Affordability and bill profile

6.1 Bill profile

South Staffs Water's acceptability research, undertaken in March 2019 with a representative sample of 738 customers, outlines that 74% of customers find its nominal terms water bill to be acceptable. The company's business plan reports acceptability as 76% as it includes 2% of customers that responded 'don't know' in the affirmative - we do not regard this to be good practice as it overestimates the level of customer support. The company does not test the acceptability of real terms bills or combined water and wastewater bills.

South Staffs Water tests customer preferences separately on its five year and ten year bill profiles. For the ten year exercise it tests preference between one bill that rises slowly throughout and another that is flat for 2020-25 and then rises in 2025-30. On this question, 66% of customers prefer a profile that rises throughout with only 34% preferring a flat bill in 2020-25 followed by greater increases in 2025-30. The company's five year research indicates that around 80% of customers prefer a flat nominal bill to a rising one, so it proposes to maintain a flat bill in 2020-25, with increases thereafter. However, we note that when asked for their views over both the five and ten year periods, a significant number of respondents (41%) switch their preference from flat bills over five years, to a steadily rising bill over ten years. The customer challenge group states that, 'the strongest support in both lots of research was registered for a flat bill in AMP7 and the Company is respecting that.'

Taking account of its acceptability results and its inconsistent approach to interpreting the results of bill testing over five year and ten year periods, South Staffs Water in the round provides insufficient evidence on the acceptability of its bills. This is particularly important given that the company's plan to have a flat nominal bill means it proposes to use pay as you go levers to bring money forward (as detailed in section 4.2), take all under and outperformance payments at the end of the 2020-25 period and true-up for inflation on the same timeline. We are rejecting the company's proposal as we consider it could lead to customer detriment through a step-change in bills in the 2025-30 period, and could have limited customer benefit due to the flat nominal bill only being for the water bill (the wastewater bill could still rise). In effect, South Staff Water ask customers to pay for expected inflation impact in advance by smoothing nominal bills, as bills are higher earlier in the period and lower later in the period, compared to flat real bills. Further, we consider that it is in the best interests of customers for financial incentives to be aligned closely with the performance which leads to them, so are requiring the company to take outperformance and underperformance payments in period. However, in setting the bill profile for the draft determination we have given consideration to maintaining movements in bills of less than £3 as per the preference established in the company's customer engagement.

The average bill profile put forward by South Staffs Water provides a bill that falls across the 2020-25 period, with a total reduction of 8.9%. Our amended profile increases this to a reduction of 17.3%. The table below sets out the difference in bills between the company's submission and our amended draft determination figures. We have adjusted the bill profile so that it provides an initial fall in 2020-21, and then remains flat in nominal terms.

Table 6.1: Bills in real terms

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan	£140	£138	£135	£133	£130	£128
Bill profile – before re-profiling	£140	£124	£121	£121	£118	£117
Draft determinations	£140	£125	£122	£120	£118	£116

Table 6.2: Long term bills

	2020-25	2025-30
Company view of plan	£133	£124

6.2 Help for customers who are struggling to pay

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

In addition, South Staffs Water commits to:

- increase the number of customers that receive support through its affordability schemes from around 31,000 in 2019-20 to 40,000 by 2024-25;
- increase its cross-subsidy to £3 to deliver its ambition on social tariffs. Additionally, the company will seek customer support to increase this in-period in order to support its aim of helping more people; and
- introduce new affordability schemes, including payment matching and a new hardship fund.

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

- improve customer views of value for money;
- increase the number of customers it supports financially through its affordability schemes to 40,000;
- provide a number of its Priority Services Register customers with an enhanced package of support through its Extra Care scheme.

Companies will be reporting their performance against the Priority Services Register 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 6.3 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 6.3: Allowed revenue by year (£ million, 2017-18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water resources	8.9	8.9	9.3	9.4	9.3	**45.9**
Water network plus	97.0	95.6	93.8	87.2	86.4	**460.1**
Residential retail	13.2	13.0	12.8	12.6	12.4	**63.9**
Total	**119.2**	**117.5**	**115.9**	**109.2**	**108.0**	**569.8**

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

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

Table 6.4 sets out the K factors in each year for each of these two 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 6.4: Base Revenue and K factors by charging year (2017-18 prices)

	Base (£ million)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	8.9	0.00%	0.06%	3.65%	1.87%	-1.31%
Water network plus	97.0	0.00%	-1.50%	-1.84%	-7.20%	-0.98%

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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