December 2019

PR19 final determinations

PR19 final determinations: South Staffs Water final determination

Ofwat

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About this document

This document supports the 'Notification of the final determination of price controls for South Staffs Water' and sets out further details about the final determination price control, 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 final determination documentation 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.

This final determination is in accordance with our PR19 methodology (as updated), our statutory duties[1] and the UK Government's statement of strategic priorities and objectives for Ofwat[2]. We have also had regard to the principles of best regulatory practice, including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

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

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

If South Staffs Water accepts our final determination, it will be accepting that it has adequate funding to properly carry out the regulated business, including meeting its statutory and regulatory obligations, and to deliver the outcomes within its final determination.

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

Contents

1 Summary

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

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

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

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

1.1 What our final determination includes

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

Bill profile

Our final determination for South Staffs Water will cut average bills by 10.3% 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, our draft determination and the final determination. Average bills are lower than proposed by South Staffs Water, reflecting our view of efficient costs and a reduction in the allowed return. Further details on bills are set out in section 6.

Table 1.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan (April resubmission)	£140	£138	£135	£133	£130	£128
Draft determination	£140	£125	£122	£120	£118	£116
Final determination	£140	£136	£134	£131	£128	£126

Costs

Our final determination allows wholesale totex of £572.5 million. This is:

- £29.7 million higher than in our draft determination and
- £10.6 million lower than stated in the company's representation on our draft determination.

Our final determination allows South Staffs Water £112 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £68 million to improve taste/odour/colour at Hampton Loade and Seedy Mill water treatment works, and address the risk of poor water quality;
- £13 million to address the impacts of deteriorating raw water quality;
- £11.4 million for new meter installations; and
- £9 million to improve the environment by efficiently delivering its obligations as set out in the Water Industry National Environment Programme (WINEP).

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

Outcomes for customers

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

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

Table 1.2: Key performance commitments for South Staffs Water

Area	Measure
Key common performance commitments	• 15% and 13.8% leakage reduction on a three year average basis respectively on the South Staffs and Cambridge regions. This is at least 15% reduction from PR14 performance commitment levels • 1% and 6.3% reduction in per capita consumption by 2024-25 in the South Staffs and Cambridge regions respectively • 29% reduction in water supply interruptions by 2024-25 to 5 minutes
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 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.
Overall incentive package	Overall, the likely range of returns from outcome delivery incentive package in our final determination equates to a return on regulatory equity range of – 2.90% (P10) to + 1.46% (P90).

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

Allowed revenues

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

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

	Water Resources	Network plus - water	Wholesale total	Residential retail	Total
Company view of allowed revenue (£m)	51.6	534.0	585.6	62.3	647.9
Final allowed revenues (£m)	47.8	506.2	554.0	64.0	618.0

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

As set out in the 'Allowed return on capital technical appendix', we are updating our assessment of the allowed return on capital for South Staffs Water's final determination. The sector allowed return is 2.96% (on a CPIH basis, 1.96% on a RPI basis) at the appointee level. After adjustment for the retail margin, the allowed return on capital for the wholesale price controls at a sector level is 2.92% (on a CPIH basis, 1.92% on a RPI basis), a reduction of 0.16 percentage points from our draft determination, reflecting our assessment of market evidence.

For South Staffs Water we have accepted the request set out in its representation for a company-specific adjustment to the allowed return on debt, uplifting the allowed return for the wholesale controls equivalent to 3.11% (on a CPIH basis, 2.11% on a RPI basis). The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

South Staffs Water's Regulatory Capital Value (RCV) growth in 2020-25 is 15.1% and 70.2% of its RCV will be indexed to CPIH in 2025. We bring forward £0.77 million of revenue from future periods.

We consider that South Staffs Water's final determination is financeable on the basis of the notional structure, based on a reasonable allowed return on capital and revenue advanced through pay as you go (PAYG) adjustments. The determination is sufficient to deliver its obligations and commitments to customers. Further detail on our assessment of financeability is set out in section 5.

Putting the sector in balance

We have encouraged companies to take greater account of customers' interests – and to transparently demonstrate that they are doing so in the way they finance themselves, pay dividends to their shareholders, and determine performance related executive pay. South Staffs Water commits to meeting the expectations set out in our 'Putting the sector in balance position statement'.

Under its actual financial structure, South Staffs Water expects its gearing to be close to the level that will trigger sharing payments under the gearing outperformance sharing mechanism in 2020-25. We have not accepted the company's proposal that its own definition of gearing should be used for the calculation of benefit sharing because it does not deliver equivalent benefits for customers, in the round, as our mechanism. But we have amended our mechanism to include a transition period in 2020-25

To meet our expectations, the company will need to demonstrate to stakeholders that dividend and performance related executive pay policies are substantially aligned to its performance for customers during the 2020-25 period.

In the 'Putting the sector in balance' position statement we also encouraged companies to adopt a voluntary sharing mechanism, particularly where, for example, companies outperform our cost of debt assumptions. South 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.

We provide further detail on these issues in section 7.

1.2 Representations on the draft determination

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

Table 1.4: Company representation

Key point in South Staffs Water representation	Summary of our response
South Staffs Water argues that Ofwat's approach to outcome delivery incentives means companies must deliver upper quartile performance to earn the cost of capital.	Our final determinations are intended to be stretching but achievable for companies to deliver improved levels of service in 2020-25. We have taken account of evidence provided by the company as well as wider evidence to calibrate the stretch of the performance

Key point in South Staffs Water representation	Summary of our response
	commitment for an efficient company. See section 2.
South Staffs Water 'reluctantly' accepts our draft determination's approach to replicating a flat nominal bill and to require that some performance commitment incentives are in-period. South Staffs Water notes its customer research and customer preference for flat and stable bills.	We continue to seek to replicate the flat nominal bill approach proposed by the company and continue to set in-period outcome delivery incentives. See section 6.
South Staffs Water argues that it is not financeable based on the draft determination and Ofwat is not acting consistently with its legal duties to allow an efficient company to finance its functions. South Staffs Water says that the reduction in the allowed return on capital, the tougher outcome delivery incentives regime and reduced enhancement totex means it needs a 24bps company-specific adjustment to the cost of capital based on a 40bps adjustment to cost of debt. It evidences customer support and customer benefits. The Board of South Staffs Water has expressed serious concerns that the draft determination does not allow the company sufficient funding to fulfil its obligations. It says it is not a financeable plan on either an actual or notional basis but that if its representations are accepted, with mitigations available, the company will remain financeable on both. The company's Board assurance statement says that if there is any significant further reduction in the cost of capital, the company may be unable to maintain financial resilience in either the actual or notional structure. It says it would require either a further increase in the company-specific cost of debt uplift or an adjustment to the PAYG rate to accelerate revenue from further periods.	We have carefully considered all of our duties, in particular our financing functions and consumer protection duties, and are satisfied that our final determination fulfils our duties in the round. Our assessment of notional financeability for the final determination is made in the context of changes made to the draft determination in our final determination. We consider the company's final determination is financeable on the basis of the notional structure based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure the company will be in a position to deliver its obligations and commitments to customers. It is the company's responsibility to maintain financial resilience under its actual financial structure and it must bear the risks associated with its choice of capital and financing structure. We have based our final determination on target credit ratings and ratios consistent with South Staffs Water's business plan. We note that our final determination is based on South Staffs Water being an efficient company, as we do not consider customers should bear costs associated with inefficiency or poor performance. We use an allowed return on capital based on updated market evidence, as set out in our 'Allowed return on capital technical appendix'. We have considered whether the evidence provided by the company supports its company-specific adjustment application satisfies our three-stage assessment criteria, and we have allowed a 33 basis points adjustment to the cost of debt. This uplifts the allowed return for the wholesale controls equivalent to 3.11% (on a CPIH basis) or 2.11% on a RPI basis. See section 4.
South Staffs Water argues against our intervention to allow only £6 million of its £18 million developer services revenue claim in the wholesale revenue forecasting incentive	We now accept more elements of the company's claim and allow £12.3 million (nominal prices) of the claim in WRFIM. We do not accept the elements of the claim not related

Key point in South Staffs Water representation	Summary of our response
mechanism (WRFIM), it considers not allowing the full claim for efficiently incurred costs is a penalty.	to the variance in the volume of new connections because we consider them outside of the mechanism's scope.
South Staffs Water argues that the skew towards underperformance means the company will receive penalties in 2020-25 at P90 performance. South Staffs Water argues that the relative size of Hampton Loade and Seedy Mill treatment works distorts its compliance risk index (CRI) score (which measures compliance with the Drinking Water Inspectorate's (DWI's) water quality standards), where it is undertaking works for 2023 and 2024. South Staffs Water proposes to either descale the penalty rate to achieve the same average risk range or to exclude Hampton Loade and Seedy Mill from penalties until they are no longer under DWI notices.	On compliance risk index, we note the high relative size of the two treatment works as a proportion of overall supply volume, and that the company's P10 for this performance commitment as a percentage of its RoRE is an industry outlier. We amend the deadband to 2.0 for all companies. We acknowledge that, even with a large improvement, the company is likely to incur underperformance payments for compliance risk index as a result of poor performance. Companies are expected to maintain compliance during works and we would also expect the company to put in temporary mitigations to minimise the risk of failures. We are also introducing a collar[3] to limit the company's exposure to potential underperformance payments. See section 2.
South Staffs Water disagrees with our approach to triangulating (using different information to help set rates) incentive rates, and so disagrees with the incentive rate increases for compliance risk index, supply interruptions, customer contact about water quality and mains bursts.	The incentive rates the company proposes are lower than industry average and we remain concerned about this for different reasons for each performance commitment (for example poor past performance). We are setting more appropriate incentive rates using its customers' valuations as well as other relevant information such as the corresponding incentive rate in the 2015-20 period and the industry average incentive rates. See section 2.
South Staffs Water challenges our approach to leakage expenditure, arguing that it cannot achieve its leakage reduction without £10.3m enhancement spend, which it provides additional evidence for. South Staffs Water argues that leakage spend is enhancement by definition because the 15% target is effectively a new statutory requirement.	In our PR19 methodology one of our challenges to companies was to reduce leakage by 15% or justify why this could not be achieved. This is not a statutory requirement. At draft determination, we accepted the 19% leakage reduction (13.8% in Cambridge and 21% in South Staffs). We amend the South Staffs region leakage reduction from 21% to 15% on a 3-year average since we consider this is stretching and consistent with the wider sector challenge to reduce leakage with base cost allowances. We expect an efficient company to achieve its stretching performance commitments from our base allowance. As South Staffs Water's leakage performance commitment does not go beyond the industry forecast upper quartile

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

Key point in South Staffs Water representation	Summary of our response
	threshold we make no allowance (see section 3).
South Staffs Water provides additional evidence to support new connections of around 31,000 in 2020-25 and argues that the Office of National Statistics' (ONS) expected fall in the growth rate is unsupported and points to 14,000 sites in development.	We use the ONS as an independent source of data widely used for forecasting. The number of new connections in the South Staffs area varies significantly over time, so we do not use its forecast or recent historical growth to forecast 2020-25 connections. See section 3.
South Staffs Water requests £68.5 million for upgrades to Hampton Loade and Seedy Mills water treatment works.	Our allowance increases from £63 million to £68 million based on new information. See section 3.

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

Table 1.5: Stakeholder representations

Stakeholder representations	Summary of our response
The Consumer Council for Water (CCWater) broadly supports the draft determination, welcoming the company's resilience strategy and suggesting that compliance risk index should include Hampton Loade and Seedy Mill, with penalties applied once improvements are made. It argues Ofwat should reconsider the flat bill profile to reflect customer preferences and that the benefits of any company-specific adjustment should outweigh the additional cost.	We continue to include Hampton Loade and Seedy Mill in the compliance risk index throughout the period. The company is expected to maintain compliance during any works. We provide the company with an appropriate company-specific adjustment for the cost of debt and seek to replicate the flat nominal bill approach. We partially replicate a flat bill profile, while declining to make all outcome delivery incentives occur at the end of 2020-25. See section 2.
The South Staffs Customer Panel, the South Staffs Water customer challenge group, states that the customer research on the company-specific adjustment was effective, argues that Ofwat should respect customer support for flat nominal bills and welcomes the commitment to fund amber WINEP schemes via cost enhancement.	We allow South Staffs Water a company-specific adjustment and our approach to bills partially replicates the flat nominal bill approach. See section 5 and section 6.

1.3 Key changes from the draft determination

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

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

	Draft determination	Final determination
Allowed revenues (£m, 2017-18 CPIH deflated)	569.8	618.0
Wholesale cost allowance[1] (£m, 2017-18 CPIH deflated)	542.8	572.5
Retail cost allowance (£m, nominal)	62.3	62.3
Wholesale allowed return[2] (% - CPIH basis)	3.08%	3.11%

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

Significant changes from the draft determination for South Staffs Water are:

- On mains repairs, we make changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction levels for mains repairs.
- We amend the leakage reduction for the South Staffs regions from 21% to 15% on a three year average basis which we consider stretching and consistent with the wider sector challenge to reduce leakage with base cost allowances.
- We amend the deadband on the compliance risk index to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25.
- We amend the collars4 for mains repairs, compliance risk index, and water supply interruptions performance commitments.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the outcome delivery incentive underperformance rate to be symmetrical with its outperformance rate.

- We revise our base notional dividend yield for the sector to 3.00% (from 3.15% in the draft determination) with dividend growth of 1.18%. For South Staffs Water we restrict the base dividend yield to 2.16% in our notional financeability assessment due to the high level of RCV growth in the final determination.
- We revise our allowance relating to South Staffs Water's complex claim within the WRFIM. Taking account of the company's latest information, we are increasing revenue by £7.7 million compared to the draft determination.

2 Outcomes

Key changes from the draft determination

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

- On mains repairs, we make changes that apply industry wide to ensure levels take account of historical levels of performance and the implications of leakage reduction level for mains repairs.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the outcome delivery incentive underperformance rate to be symmetrical with its outperformance rate. Together these two changes provide a more balanced spread of incentives and risks on water supply interruptions
- We amend the deadband on the compliance risk index to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25 period. This allows more flexibility in performance and aligns with the median level of company performance as well as the fact that the ban on the use of metaldehyde has been overturned by the High Court.
- We amend the leakage reduction for the South Staffs region from 21% to 15% on a three year average basis which we consider remains stretching and consistent with the wider sector challenge to reduce leakage with base cost allowances.
- We amend the collars[4] for compliance risk index, water supply interruptions and mains repairs performance commitments which are material contributors to downside financial risk. When combined with the rest of the outcomes delivery incentive package, we consider the financial exposure to the company resulting from these performance commitment's underperformance would be disproportionate if we set collars following our standard approach. As such, we have reduced the financial underperformance exposure by setting the collars at a tighter level. The collars become wider over time so that the risk for the company increases and therefore we maintain the incentive to improve.

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

Throughout PR19, we have been asking companies to:

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

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

There are two key elements of the outcomes framework: performance commitments and outcome delivery incentives. Performance commitments specify the services that customers should receive and set out in detail the levels of performance that the companies commit to achieve within the five year period from April 2020 to March 2025. Outcome delivery incentives are the reputational and financial incentives that companies have, to deliver on their performance commitments to customers. They specify the financial or reputational consequences for companies of outperformance or underperformance against each of these commitments (they are referred to as 'out' where there is a payment to the company for better than committed performance, 'under' where there is a payment to customers where there is worse than committed performance, or 'out-and-under' incentives, depending on their design).

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

The company is currently showing around average performance, including on customer service, and performance has overall improved in 2018-19. The company is one of six companies to achieve net outperformance payments for performance in 2018-19.

In its April 2019 business plan, the company addressed many of the issues we had raised on its September 2018 business plan, namely it removed scaling factors on outcome delivery incentive rates. However, the company retained its proposals to keep its outcome delivery incentive rates on an end of period basis since it claimed it had retested the use of in-period incentives with its customers and they remained more supportive of flat bills over the period and hence end-period incentives. The company also proposed to amend the compliance risk index, the water quality measure, since it considers that it is exposed to an inappropriate level of financial risk on this performance commitment. The company proposed a range of approaches to addressing this risk which included amending the level at which financial incentives apply (increasing the deadband), removing its two key assets (Hampton Loade and Seedy Mills water treatment works) from the financial measure, scaling the underperformance rate or setting a tighter collar to limit its underperformance.

In our draft determination, following a review of customers' preferences and the company's rationale, we considered that the evidence provided did not sufficiently demonstrate that the proposed end of period outcome delivery incentives offer sufficient customer protection or that in-period reconciliation created a genuine risk of bill volatility for customers. See section 2.1 below. We also did not consider the company had sufficient rationale to require a different treatment to other companies on compliance risk index.

In its response to our draft determination, the company accepts the move to in-period outcome delivery incentives and the draft determination compliance risk index deadband but makes further representations on its compliance risk index underperformance rate and its level of exposure.

In its September 2018 business plan the company acknowledged poor performance from its assets: 'Based on the performance relating to water quality in recent years, we have concluded that the age and design of our two critically and strategically important water treatment works at Hampton Loade and Seedy Mill cannot consistently meet the required standards without investment. Together, these two treatment works supply water to nearly 60% of customers in our South Staffs region.'

We acknowledge that both of these sites are under Drinking Water Inspectorate notices for improvement and the company is receiving cost allowances to fund improvement at the sites and that having Drinking Water Inspectorate notices in place at a site impacts on the compliance risk index score for any failures. However, the company is expected to maintain compliance during these works which may involve adding temporary mitigations to minimise the risk of failures.

We are not proposing to exclude the sites from the measure or change the outcome delivery incentive rate. However, if we set collars following our standard approach, we consider that the financial exposure to the company resulting from underperformance related to the compliance risk index would be disproportionate. We have therefore reduced the financial underperformance exposure by setting the collars at a tighter level, in this case so that the maximum underperformance payments do not exceed 1% of return on regulatory equity. The collars become wider over time so that the risk for the company increases and therefore we maintain the incentive to improve.

The company further argues that Ofwat’s interventions in incentive rates for mains bursts, customer contact about water quality and supply interruptions go against the results of its customer research and its approach to setting its outcome delivery incentive rates (triangulation). The main reason the company gives is that our rates are averaged using points in the reasonable range of industry outcome delivery incentive rates and thus do not reflect their customers' preferences. Our methodology for assessing outcome delivery incentive rates considers reasonable ranges based on company business plan submissions. This is because using a reasonable range based on data across the sector mitigates the risk of methodological differences leading to outcome delivery incentive rates which depart from underlying customer preferences.

Our approach uses the reasonable range proportionately as one element of our analysis and we conscientiously consider companies’ research as well as several other factors such as large variance from PR14 rates, comparative performance as well as past performance issues. If the research is considered good quality, it is included in the data we use to set outcome delivery incentive rates for customer facing performance commitments. Consequently, we consider our use of reasonable ranges to be proportionate and consistent, and that, in setting rates, we balance our use of reasonable ranges with additional information including companies’ evidence.

We consider that past performance is a relevant consideration when setting outcome delivery incentive rates. There is a risk that companies with poor past performance may propose weak incentives, whereas, we consider they may require stronger financial incentives than in previous periods, to ensure that they place due focus on improving performance in this specific area. As such, we use a range of tests as articulated in our ‘Delivering outcomes for customers policy appendix’.

For South Staffs Water, we only intervene where we have significant concerns about the way that the company has derived incentives rates. For example, in the case of supply interruptions we are concerned that the rate proposed by the company is materially lower than the rate proposed in PR14 as well as being lower than our reasonable range. Therefore we continue to propose to set its outcome delivery incentive rates by averaging using the proposed rate, the PR14 rate and the lower bound of the reasonable range. We assess each of these claims on the specific rates in ‘South Staffs Water - Delivering outcomes for customers final decisions’.

In its representation on its draft determinations the company argues that it cannot deliver the leakage reduction it has put forward without additional funding see 'Securing cost efficiency technical appendix'. We note that the company's proposal on the leakage performance commitment level for the South Staffs region is 21% on a three year average bases. We are reducing this to 15% on a three year average basis which we consider stretching and consistent with the wider sector challenge to reduce leakage with base cost allowances. The company can earn outcome delivery incentives, if it improves performance beyond stretching levels to fund further service improvement, including Water Resource Management Plan levels where these go beyond the performance commitment level. We note the company is meeting its leakage levels in PR14.

The outcomes framework sits in the broader context of the company's statutory and licence requirements for service delivery. Independently of the outcomes framework, each company also has to ensure that it complies with its legal obligations, or risk enforcement action. If a company's performance falls below the level set for a performance commitment (irrespective of the existence of any deadband or collar), we will consider whether this is indicative of wider compliance issues to the detriment of consumers and whether enforcement action, with the potential for remedial and fining measures, is warranted.

Please see the 'Delivering outcomes for customers policy appendix' for further details on our policy decisions on cross-cutting issues such as common performance commitments and outcome delivery incentive rates.

2.1 Customer engagement

In our PR19 methodology we set out our expectations that companies should demonstrate ambition and innovation in their approach to engaging customers as they develop their business plans. This includes direct engagement with customers to develop a package of performance commitments and outcome delivery incentives.

We expected customer challenge groups to provide independent challenge to companies and independent assurance to us on: the quality of a company's customer engagement and the degree to which this is reflected in its business plan.

We continued our assessment of customer engagement evidence following each company's submission of its representations to our draft determination in August 2019. We find variability in both the quality of engagement undertaken by companies and the extent to which customers' views are reflected in company proposals.

In its September 2018 business plan, South Staffs Water provided evidence to demonstrate elements of high-quality customer engagement although we highlighted some areas of concern in our initial assessment of the company's plan, such as insufficient evidence of customer views being reflected in outcome delivery incentives due to its approach to averaging across its customer valuation research in setting its outcome delivery incentive rates.

In response to our initial assessment, in its April 2019 revised business plan, the company updated parts of its original September 2018 business plan, explaining that it has 'carried out more specific engagement with customers on incentives, including the use of caps, collars and rewards'. We found this research to be of satisfactory quality.

South Staffs Water submitted new customer engagement research with its August 2019 representations to our draft determinations that considered whether customers support paying a company-specific adjustment on their bill. The company satisfied the 'customer support' approach of our three-stage criterion for assessing company-specific adjustment claims, with evidence that convincingly demonstrated that a majority of customers are likely to support funding its proposed level of uplift (as set out in our PR19 methodology). The company customer challenge group submitted representations to our draft determination, in which it provided quality assurance of the new customer engagement research submitted by the company.

In its representations to our draft determination, South Staffs Water states that some of our interventions on its outcome delivery incentive rates go against its view of customer valuations. We find that the company has not submitted sufficient or convincing evidence that we should change our interventions at draft determination and are concerned that the company has not accurately reflected customer preferences in its proposed incentives rates see section 2 above for further details.

At draft determination, we intervened to make seven of the South Staffs Water outcome delivery incentives in-period, in its representations to our draft determination the company states that these interventions go against its customers preferences and therefore proposed end-of-period outcome delivery incentives for seven performance commitments that it stated were susceptible to volatility, including leakage, per capita consumption, water supply interruptions, compliance risk index, mains repairs and unplanned outages.

While the company provides high quality customer engagement evidence in support of flat bills, the evidence on customer support for end-of-period outcome delivery incentives as a way of managing this is more mixed (with 66% of customers appearing to support a bill profile that implies in-period outcome delivery incentive adjustments). We do not consider that bill smoothing is a legitimate reason for end-of-period outcome delivery incentives, because the company will be able to smooth bills over the period, through its in-period adjustments, if there are excessive changes in bills as a result of its outcome delivery incentive under or over-payments. The company does not submit any additional evidence in its representation to support its claim that its customers' preferences of a flat and stable bill support end-of-period incentives for the majority of its common and comparable performance commitments. We note that the company accepts our draft determination intervention and we are retaining it for our final determination.

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

2.2 Performance commitments and outcome delivery incentives

South 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 full details of these performance commitments and outcome delivery incentives are set out in the 'South Staffs Water - Outcomes performance commitment appendix'.

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

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

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

Key changes
Increasing the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the underperformance rate to be symmetrical with its outperformance rate. Together these two changes provide a more balanced spread of incentives and risks on water supply interruptions. Amending the collar on water supply interruptions - see below.
Adjusting the deadband on the compliance risk index to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25 period. This allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court and also aligns with the median level of current company performance. Amending the collar on compliance risk index – see below.
Increasing the performance commitment levels for mains repairs by a reducing percentage, for all companies, in all years, reducing the stretch. The aim is to allow all companies the flexibility to deliver the step change in leakage reduction, allowing more flexibility in the earlier years to use proactive mains repairs to reduce leakage.
We are amending the company's proposal on the leakage performance commitment level since the company is proposing to achieve at least a 15% improvement on PR14 levels and that it can earn outcome delivery incentives, if it improves performance beyond stretching levels to fund further service improvement including Water Resource Management Plan levels where these go beyond the performance commitment level. We note the company is meeting its leakage levels in PR14.
We are amending the collars for compliance risk index, water supply interruptions and mains repairs performance commitments which are material contributors to downside financial risk. When combined with the rest of the outcomes delivery incentive package, we consider the financial exposure to the company resulting from these performance commitment's underperformance would be disproportionate if we set collars following our standard approach. As such, we have reduced the financial underperformance exposure by setting the collars at a tighter level. The collars become wider over time so that the risk for the company increases and therefore we maintain the incentive to improve.

Table 2.2: Summary of performance commitments: common performance commitments

Name of common performance commitment	Type of outcome delivery incentive			
	Financial			Reputational
	Under	Out	In-period	
Water quality compliance (CRI) [PR19SSC_D1]	X		X	
Water supply interruptions [PR19SSC_D2]	X	X	X	
Leakage South Staffs region [PR19SSC_C1]	X	X	X	
Leakage Cambridge region [PR19SSC_C2]	X	X	X	
Per capita consumption South Staffs region [PR19SSC_C3]	X	X	X	
Per capita consumption Cambridge region [PR19SSC_C4]	X	X	X	
Mains repairs [PR19SSC_D4]	X	X	X	
Unplanned outage [PR19SSC_D5]	X	X	X	
Risk of severe restrictions in a drought [PR19SSC_D3]				X
Priority services for customers in vulnerable circumstances [PR19SSC_B4]				X
C-MeX: Customer measure of experience [PR19SSC_A1]	X	X	X	
D-MeX: Developer services measure of experience [PR19SSC_A2]	X	X	X	

Table 2.2: Summary of performance commitments: bespoke performance commitments

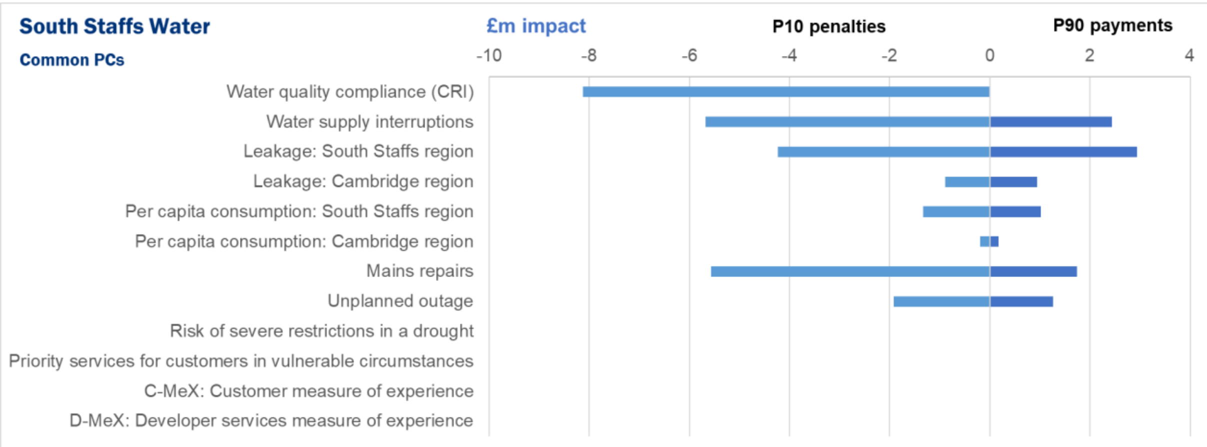
Name of bespoke performance commitment	Type of outcome delivery incentive				
	Financial				Reputational
	Under	Out	In-period	End of period	
Retailer measure of experience [PR19SSC_A3]					X
Financial support [PR19SSC_B1]	X		X		
Extra Care assistance [PR19SSC_B2]	X		X		
Education activity [PR19SSC_B3]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

Figure 2.1 and figure 2.2 provide an indication of the financial value of each of South Staffs Water's outcome delivery incentives (taking into account the impact of our final determination decisions) showing how much the company would have to return to customers if it underperformed to the P10 level and how much the company would gain if it outperformed to the P90 level. The P90 is the performance threshold at which there is only a 10% chance of outturn performance being better. The P10 is the performance threshold at which there is only a 10% chance of outturn performance being worse.

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

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

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



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

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

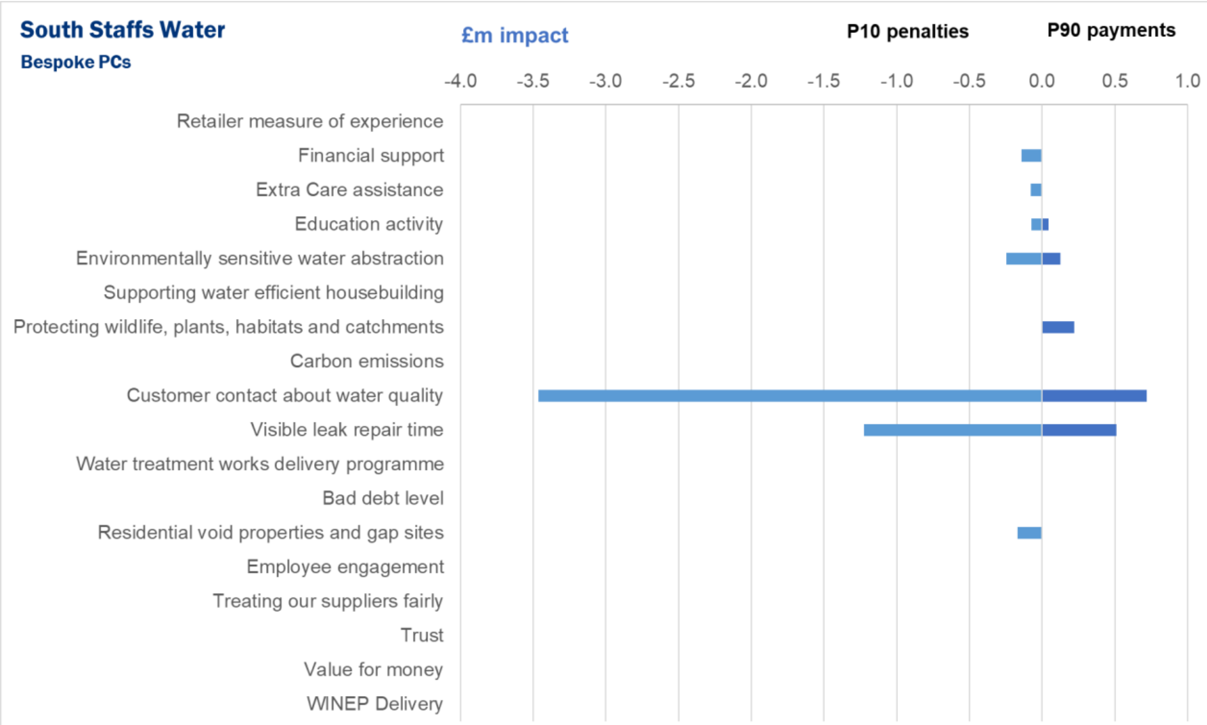


Table 2.4 provides an indication of the financial value of the overall package at the upper and lower extreme levels of performance (expressed as a percentage point impacts on RoRE (return on regulatory equity)) and the overall impact of our final determination decisions. Further information on how we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

Table 2.3: Impact of draft determination and final determination decisions on RoRE range

	Draft determination % of 5 year regulatory equity		Final determination % of 5 year regulatory equity	
	P10	P90	P10	P90
South Staffs Water	-2.72	+0.43	-2.90	+1.46

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

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

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

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

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

2.3 Delivering a framework for resilience in the round

Resilience is one of our four themes for PR19. We set out our expectations for water companies' business plans in our PR19 methodology. Overall, South Staffs Water's September 2018 business plan falls significantly short of demonstrating it has applied an integrated resilience framework that will deliver resilience in the round. It does however provide evidence that the company has undertaken a holistic review of its resilience and identified a long list of risks. It also considers a wide range of mitigation options and provides evidence of partnership working to develop resilience through nature-based options.

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

Overall, South Staffs Water's resilience action plan includes some good elements but falls short of our expectations in many areas. In particular, we are concerned that:

- the company does not demonstrate how the maturity assessment has been used to identify specific priority actions for resilience improvements. We expect the company to clearly demonstrate how its action plan is influenced by an understanding of its baseline maturity;
- the company does not respond to our feedback from the initial assessment of business plans, particularly around providing evidence of an integrated and systems-based approach to resilience and the assessment and prioritisation of risks on resilience. We expect the company to clearly respond to our feedback and demonstrate how this informed the development of its action plan; and
- the company's action plan lacks sufficient detail to give us confidence it has a robust plan is in place to deliver an integrated resilience framework. We expect that the company's resilience action plan would provide sufficient detail to demonstrate a robust path to implementing its action plan, including clear governance and accountable owners for actions.

South Staffs Water provides evidence of collaboration with other organisations to enhance natural capital. The company also identifies the 'desired states' that represent what good resilience looks like. However, these are not developed in sufficient detail to give us confidence that the company can deliver these desired states.

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

3 Cost allowances

Key changes from the draft determination

- Our final determination allowance for South Staffs Water is £572.5 million for the wholesale services. This compares with £542.8 million at draft determination. In retail, our final determination allowance is £62.3 million, which is unchanged from the draft determination.
- Our base allowance is affected by a number of changes we have made since draft determinations:
  - we include company outturn data from 2018-19 in our econometric models;
  - we exclude non-section 185 diversions costs (i.e., diversions other than those required by section 185 of the Water Industry Act 1991) from our econometric models and allow companies to recover related income outside the price control, from the relevant transport authority;
  - we strengthen the catch-up challenge applied to wholesale modelled base costs. We use the 4th placed company as an efficiency benchmark, rather than the 5th place (upper quartile) company at draft determinations;
  - we reduce the frontier shift challenge from 1.5% per year to 1.1% per year, but we extend to all wholesale base costs.
- We make a £2.4 million downward adjustment to our base allowance for water network plus. The adjustment is due to a relatively low forecast of population growth in 2020-25 in the company's supply area.
- For final determinations we apply a frontier shift challenge of 1.1% per year to metering enhancement costs.

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

In its September 2018 business plan and the revised plan in April 2019, South Staffs Water's expenditure proposals are significantly above what it has incurred historically in wholesale services. We considered that the company's expenditure proposals for wholesale services were inefficient. We challenged the efficiency of its proposed costs and investment programme to ensure customers pay only for efficient costs. In its response to our draft determinations in August 2019, South Staffs Water reduces its requested costs significantly. As a consequence of this, and additional cost allowances that we make, the total cost gap at final determination reduces from 9% to 1%.

Our main challenge on the company's proposed costs relates to enhancement proposals. On base costs, the company's proposed costs in its August 2019 representation to the draft determination are efficient.

In residential retail we assess South Staffs Water's expenditure proposals as efficient.

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

3.1 Allowed expenditure for wholesale services

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

Table 3.1: Totex[1] by year for wholesale controls, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total	Company August 2019 - total
Water Resources	12.2	10.6	10.1	10.2	10.6	53.7	57.0
Water network plus	109.0	113.9	114.6	89.7	91.6	518.8	526.0
Total	**121.3**	**124.4**	**124.7**	**99.9**	**102.2**	**572.5**	**583.0**

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

Table 3.2 sets out the components of our totex allowance. The main components are base and enhancement costs. Base expenditure refers to routine, year on year costs, which companies incur in the normal running of their business to operate, maintain and incrementally improve service to customers. Enhancement expenditure refers to investment for the purpose of enhancing the capacity or quality of service beyond base level.

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

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

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

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

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

	Water resources	Water network plus	Total
Base expenditure	41.7	400.1	441.8
Enhancement expenditure	11.1	100.5	111.6
Operating lease adjustment	-	-	-
Gross allowed totex for calculation of cost sharing rates	52.8	500.6	553.4
Strategic regional water resources solutions and other cash items	-	-	-
Third party costs	0.0	6.8	6.8
Non-section 185 diversions	-	2.6	2.6
Ex-ante cost sharing adjustment	-	-	-
Gross totex	52.8	510.0	562.8
Grants and contributions after adjustment for income offset[1]	-	51.1	51.1
Net allowed totex used in PAYG calculation	52.8	458.9	511.7
Pensions deficit recovery costs[2]	0.8	8.9	9.7
Total	**53.7**	**3.7**	**3.4**

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

Movement in allowed wholesale expenditure between draft and final determinations

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

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

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

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

Price Control	Company April 2019	Company August 2019	Draft determination allowance	Final determination allowance
Wholesale water	598.0	563.7	526.1	553.4

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

	Draft determination allowance	Final determination allowance
Base expenditure	425.0	441.8
Enhancement	101.1	111.6
- Environmental obligations (WINEP)	6.5	8.8
- Supply-demand balance and metering enhancement	17.7	17.3
- Resilience enhancement	0.4	1.9
- Other enhancement (e.g. investment to address raw water deterioration, improve taste/odor/color and meet lead standards)	76.6	83.7

3.2 Wholesale base expenditure

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

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

Price Control	Company August 2019	Final determination allowance
Water Resources	44.3	41.7
Water Network plus	390.8	400.1
Total	**435.2**	**441.8**

Company business plan base costs exclude enhancement opex.

For final determinations, we retain our approach of including growth related expenditure in our base econometric models. We have also made an adjustment depending on whether the company operates in an area with a relatively high or low forecast of population growth, relative to the historical average for the sector. This follows representations made at draft determinations that the models did not adequately compensate for companies with a high growth forecast. We also consider that the models overcompensate for companies that operate in an area with a low growth forecast. We consider that using the symmetrical adjustment approach set out in our PR19 methodology best accommodates for these factors.

As the population growth forecast in South Staffs Water's area for the period 2020-25 is lower than the historical average growth rate in the sector, we make a downward adjustment of approximately £2.4 million to the company's wholesale water base allowance. More details of our approach can be found in the 'Securing cost efficiency technical appendix'.

South Staffs Water challenges our use of the Office of National Statistics (ONS) household projection rates to forecast new connections, considering it does not take into account the most up to date information and underestimates the number of connections that will occur. The company considers that its forecast of new connected properties, which uses data at Local Authority level, is more appropriate. Local authority forecasts tend to be at the upper end of the range of possible growth rates and may be appropriate for long-term supply-demand balance planning. However, we maintain the view that ONS household projections are appropriate to set efficient base allowances and do not expose companies to undue regulatory risk over a five year period. We acknowledge the pragmatic approach the company has taken in revising down its new connection forecasts in its representation to the draft determination, but consider there is no reason to diverge from the use of ONS growth rates for South Staffs Water. The number of new connected properties in its operating area varies significantly over time, which makes it difficult to justify placing more weight on recent evidence for South Staffs Water.

In its representation, South Staffs Water argues that our modelling approach does not adequately account for the increased treatment complexity that it will need to deliver and, as a result, underestimates the totex allowance in the water networks plus price control. We accept the representation. The company shows sufficient evidence that its projected investment in drinking water quality would lead to a step change in its water treatment complexity in 2020-25, and this is consistent with our assessment of its drinking quality programme. Considering the company's representation as well as representations from Yorkshire Water and Southern Water, we replace our own forecast of complexity (which was based on historical levels) with the companies' forecast level of water treatment complexity.

3.3 Enhancement expenditure

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

Table 3.6 summarises our allowances for enhancement expenditure.

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

Price Control	Company August 2019	Final determination allowance
Water Resources	11.9	11.1
Water Network plus	116.7	100.5
Total	**128.5**	**111.6**

Our final determination allows South Staffs Water £112 million to invest in improvements to service, resilience and the environment. Key parts of this allowance are:

- £68 million to improve taste/odour/colour at Hampton Loade and Seedy Mill water treatment works, and address the risk of poor water quality;
- £13 million to address the impacts of deteriorating raw water quality;
- £11.4 million for new meter installations; and
- £9 million for environmental obligations (WINEP).

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

Hampton Loade and Seedy Mill treatment works

South Staffs Water proposes £68.5 million to upgrade two of its major treatment works to reduce the risk of poor water quality. The company revises its requested cost down from £74 million it requested in its April 2019 business plan. The company sets out sufficient and convincing evidence for its need to invest in its treatment works to meet regulatory and customer expectations. It provides evidence for its choice of option and costs which we consider to have been developed using a robust process. However, we consider there is a small implicit allowance for maintenance of the two sites and we do not make an enhancement allowance for this component. In its representation the company provides convincing additional evidence to support the case for cleaning trunk mains. We accept the evidence and make an efficient allowance for the mains cleaning work using the company-specific efficiency factor.

Our allowance for final determination is an increase of £5 million from our draft determination allowance. We now allow £68 million enhancement funding for the improvements the company proposes. Some of this will be paid by Severn Trent Water due to its use of water treated by South Staffs Water.

Addressing raw water deterioration

South Staffs Water requests £15.9 million for investments at three water treatment works to address deteriorating raw water quality. The Drinking Water Inspectorate provides letters of support for each scheme. We make a total allowance of £12.7 million for the three schemes, which is an increase of £2 million from our draft determination allowance. The company provides evidence of appropriate option selection and a breakdown of scheme costs for two schemes and we pass the capital expenditure for these. For the Kinver-Cookley proposal, we apply a 10% challenge to the scheme costs due to insufficient evidence of the company selecting the best option. We allow the costs for catchment management activities. We do not make an enhancement allowance for the additional operating costs of more complex treatment processes. We include the company values of forecast treatment complexity to calculate our base allowances.

Environmental obligations (WINEP)

South Staffs Water requests £9.2 million for the WINEP water enhancement programme. Our final determination allowance is £8.8 million. We make additional allowances for the company’s Eels regulation and water framework directive proposals, following deep dive assessment of the additional information the company provides in its representation to the draft determination. We find insufficient evidence that its costs are efficient and apply an efficiency factor to set an efficient allowance.

Leakage

We expect an efficient company to achieve its stretching performance commitments from our base allowance. Only where the company's performance commitment goes beyond the industry forecast upper quartile leakage performance, do we make an enhancement allowance for leakage reduction. As this is not achieved by South Staffs Water, our allowance is unchanged from draft determination and we do not allow any of the requested £10.3 million under enhancement. In 'Securing cost efficiency technical appendix' we set out our policy on the funding of leakage reduction costs, including how we derive the upper quartile threshold for leakage enhancement costs.

Resilience

South Staffs Water proposes £4.1 million to enhance the resilience of its water services. At draft determination we allowed £0.4 million to protect booster pumping stations from power outages.

The company submits additional evidence with its representations to the draft determination and we accept the need to protect against mains failure at Norman Road pumping station, Town Gate and between Caxton-Gibbet and Papworth. We consider the evidence is sufficient to demonstrate that failure of these assets is low probability, beyond management control and would result in long duration water supply interruptions. We challenge the costs due to insufficient evidence that the proposed costs are efficient, and we allow an additional £0.98 million. There is insufficient evidence to demonstrate that failures at Bourn Tower and All Saints Way would result in a long duration loss of supply to customers and so we do not make an allowance for these schemes.

We accept the need to invest at Fleam Dyke borehole where water quality issues would result in the loss of this critical asset for up to three months. We allow an additional £0.56 million.

Our final determination total allowance for water resilience enhancement is £1.9 million.

3.4 Cost sharing

In the water resources, water network plus and the wastewater network plus controls we have a cost sharing arrangement. In these controls, when a company overruns its totex allowance, the additional cost incurred above our allowance will be shared between its investors and customers. When a company spends less than its totex allowance, it will share the benefits with customers.

For the draft determinations we calculated each company's cost sharing rates based on the ratio of the company's view of costs in its September 2018 business plan relative to our view of efficient costs. For the final determinations, we calculate the company's view of costs based on a 50% weight on the company's final cost proposals in its August 2019 representation to the draft determination and 50% weight on the September 2018 business plan. We explain our approach to calculating cost sharing rates in the 'Securing cost efficiency technical appendix'.

Table 3.7 sets out the cost sharing rates for PR19 and net totex that is subject to cost sharing at the end of the 2020-25 period. We calculate cost sharing rates based on totex gross of grants and contributions (but after making adjustments for operating leases and excluding costs of strategic regional water resources development costs, third party costs and pension deficit recovery costs). At the end of the 2020-25 period, we will apply cost sharing to totex net of grants and contributions.

For final determination we introduce an uncertainty mechanism for business rates and abstraction charges. Under the uncertainty mechanism these costs are subject to different cost sharing rates. We discuss the uncertainty mechanism in section 4.4.5. Our allowance for business rates and abstraction charges costs are excluded from table 3.7.

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

	Water resources	Network plus - water
Totex for cost sharing rates – September 2018 business plan	54.2	543.5
Totex for cost sharing rates – August 2019	56.2	507.5
Weighted company view of totex for cost sharing rates	**55.2**	**525.5**
Gross allowed totex for cost sharing rates	**52.8**	**500.6**
Cost sharing ratio	1.05	
Cost sharing rate – outperformance	45%	
Cost sharing rate – underperformance	55%	
Grants and contributions before the deduction of income offset (£m)	-	68.3
Abstraction charges and business rates	16.0	24.6
Net allowed totex subject to cost sharing reconciliation	**36.8**	**407.7**

3.5 Allowed expenditure in residential retail

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

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

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

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	12.2	12.3	12.5	12.6	12.7	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.

3.6 Direct procurement for customers

We set out in our PR19 methodology that we expect company business plans to consider direct procurement for customers where this is likely to deliver the greatest value for customers. Direct procurement for customers promotes innovation and resilience by allowing new participants to bring fresh ideas and approaches to the delivery of key projects. Companies are to consider direct procurement for customers for discrete, large-scale enhancement projects expected to cost over £100 million, based on whole-life totex.

South Staffs Water's business plan does not identify any schemes that are suitable for direct procurement for customers.

We expect any major schemes which may arise due to significant changes to South Staffs Water's business plan to be reviewed against the direct procurement for customers criteria, as detailed in the PR19 methodology. If the criteria are met, we expect South Staffs Water to undertake further work to review detailed costs and commitments to ensure delivery is via the most efficient route, and to assess delivery via direct procurement for customers, to ensure that customers continue to receive the best value.

4 Calculation of allowed revenue

Key changes from the draft determination

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

- We allow £618.0 million of revenue across all price controls for South Staffs Water in the final determination, compared to £569.8 million in the draft determination and £647.9 million in the company's April 2019 revised business plan.
- The allowed return on capital for the wholesale price controls is 2.92% for the sector (on a CPIH basis, 1.92% on a RPI basis). For South Staffs Water we have included a company-specific adjustment to the allowed return on debt, uplifting the allowed return for the wholesale controls equivalent to 3.11% (on a CPIH basis, 2.11% on a RPI basis). The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.
- Consistent with the draft determination, we make a technical intervention to PAYG rates to maintain South Staffs Water's approach and take account of our view of the mix of operating and capital expenditure. We also revise our approach to determining this mix to take better account of the nature of our interventions to cost allowances.
- We increase PAYG rates to bring forward allowed revenue by £0.77 million to address a notional financeability constraint.
- Allowed revenue includes South Staffs Water's contribution to the innovation competition.
- We revise our approach to calculating grants and contributions.
- We reflect South Staffs Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission.
- We revise our allowance relating to South Staffs Water's complex claim within the wholesale revenue forecasting incentive mechanism. Taking account of the company's latest information, we are increasing revenue by £7.7 million compared to the draft determination. We explain our assessment in detail in 'South Staffs Water - Accounting for past delivery additional information.

This section sets out the calculation of allowed revenue for each of the price controls, based on our assessment of efficient costs. We set out in section 4.1 the components of allowed revenue for each of the price controls. We then set out information relevant to the calculation of the components of that allowed revenue in sections 4.2 and 4.4.

4.1 Allowed revenue

We calculate revenue separately for each of the wholesale controls and for the residential retail control. We set out the calculation of five year revenues for each of these controls in this section.

4.1.1 Wholesale controls

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

- Pay as you go (PAYG) – this reflects the allocation of our efficient totex baseline to costs that are recovered from revenue in 2020-25. The proportion of totex not recovered from PAYG is added to the regulatory capital value (RCV) which is recovered over a longer period of time.
- Allowed return on capital – this is calculated based on our assessment of the allowed return on capital multiplied by the average RCV for each year.
- RCV run-off – this reflects the amount of RCV that is amortised from the RCV in the period of the price control.
- PR14 reconciliations – this reflects the application of out/underperformance payments from PR14 through revenue adjustments in 2020-25.
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the draft determination.
- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments. It includes income from connection charges, infrastructure charges and s185 diversion recharges. The total grants and contributions amount deducted from totex may not agree to this amount, as we only include grants and contributions income relating to the price control (and some income is outside the price control).
- Non-price control income – income from charges excluded from the price controls. For example, this includes bulk supplies, standpipes, unmeasured cattle troughs, and other services. In a change from our draft determination, we also now include diversions recharges which are in respect of the New Roads and Street Works act 1991 activities and other non-section 185 diversions. We deduct

the forecast income from these charges from the allowed revenue, because costs relating to these charges are included in the calculation of allowed revenue.

- Innovation competition – this represents the additional revenue that the company will collect from its customers for the purpose of a collectively funded innovation competition for the period 2020-25. The amount each company's customers will contribute will be proportionate to individual company revenue at Draft Determinations. We expect the revenue collected from customers to be ring-fenced and administered so that it will not be used for purposes other than the innovation competition.
- Revenue re-profiling – this reflects the change in revenue in 2017-18 prices as a result of adjustments made to annual revenues to smooth the final bill profile consistent with customer preferences. The financial model calculates revenue adjustments on a net present value (NPV) neutral basis.

We set out the calculation of the allowed revenue for South 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 capital in section 4.2, the revenue adjustments for PR14 reconciliations in section 4.3, and other elements of allowed revenue in section 4.4.

Table 4.1: Calculation of allowed revenue (£ million)

	Water resources	Water network plus	Total – Final determination	Total - Draft determination
Pay as you go	34.6	300.1	334.7	293.2
RCV run-off	10.0	127.8	137.8	141.4
Allowed return on capital	2.8	52.6	55.4	56.6
Revenue adjustments for PR14 reconciliations	0.0	-5.4	-5.4	-14.3
Fast track reward	0.0	0.0	0.0	0.0
Tax	0.4	0.8	1.2	0.2
Grants and contributions after adjustment for income offset (price control)	0.0	37.5	37.5	38.1
Deduct non-price control income	0.0	-9.2	-9.2	-9.2
Innovation competition	0.0	2.0	2.0	0.0
Revenue re-profiling	0.0	-0.1	-0.1	-0.1
Final allowed revenues	**47.8**	**506.2**	**554.0**	**505.9**

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 and 1.2.

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

The adoption of innovative approaches is key to delivering long-term resilience and great customer service at an affordable price, and the sector will need to step up and increase innovation in order meet the strategic challenges it faces in a cost-effective and sustainable way. We also want to see companies work more effectively together and with their supply chain to better tackle these challenges.

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

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

In our new strategy consultation[6], we explored options for customer-funded interventions designed to drive innovation to benefit customers in the longer-term. Having reviewed the responses to the consultation, we are publishing our decision in 'Driving Transformational Innovation in the Water Sector' alongside the PR19 final determinations, confirming that we are making up to £200 million available for innovation activities for the period 2020-25 through the introduction of an innovation competition. We will work together with companies and other stakeholders in the sector to set up a competition which will effectively drive innovation in the sector to the benefit of customers across England and Wales.

4.1.2 Residential retail control

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

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

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

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

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

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

	Draft determination	Final determination
Total wholesale revenue - nominal (£m)	514.8	571.4
Proportion of wholesale revenue allocated to residential (%)	78.2%	78.2%
Residential retail costs (£m)	62.3	62.3
Total retail costs (£m)	**465.1**	**509.4**
Residential retail net margin (%)	1.0%	1.0%
Residential retail net margin (£m)	**4.7**	**5.2**
Residential retail adjustments (£m)[1]	3.2	3.3
Residential retail revenue (£m)[2]	**70.3**	**70.8**

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

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

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

4.2.1 PAYG in allowed revenue

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

We summarise in table 4.3 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 and 2.2.

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

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

	Water resources	Water network plus	Total
Totex allowance (£m)	52.8	458.9	511.7
Final determination PAYG rate (%)	63.8%	63.5%	63.5%
Pay as you go totex (£m)	33.7	291.3	325.0
Pension deficit recovery cost (£m)	0.8	8.9	9.7
Total pay as you go (£m)	**34.6**	**300.1**	**334.7**

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

	Water resources	Water network plus
April business plan (%)	68.9%	60.4%
Draft determination (%)	65.5%	56.6%
Final determination (%)	63.8%	63.5%

In the draft determination, we applied South Staffs Water's approach to PAYG rates of recovering in each year an amount equivalent to operating costs. We applied a technical intervention to amend the PAYG rates proposed in the business plan to reflect our view of the mix of operating and capital expenditure compared with the business plan. We rejected South Staffs Water's proposal to uplift PAYG rates for all wholesale controls to improve notional financeability.

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

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

Following our assessment of notional financeability of the final determination, we are increasing PAYG rates for all years for all wholesale controls by 0.12% to increase cash flows in the 2020-25 period and to align to credit ratios targeted by the company on a notional basis, bringing forward £0.77 million of allowed revenue from future periods. We set out our financeability assessment in section 5.2.

The movement in PAYG rates between the original company plan, the draft determination and final determination reflect the differences in the mix of operating and capital expenditure in totex allowance and the reduction of the PAYG adjustment for notional financeability from the company's business plan.

4.2.2 Opening RCV adjustments

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

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

	Water resources	Water network plus
RCV – 31 March 2020	379.1	
% of RCV allocated by control	3.67%	96.33%
RCV – 31 March 2020	13.9	365.2
Midnight adjustments to RCV	-0.3	-7.0
Midnight adjustments relating to operating leases	0.0	0.0
Opening RCV – 1 April 2020	13.6	358.3

4.2.3 Allowed return on capital

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

South Staffs Water's business plan incorporates the sector draft determination allowed return on capital plus a requested company-specific adjustment of 0.40% on the cost of debt. South Staffs Water's business plan incorporates the sector draft determination allowed return on capital plus a requested company-specific adjustment of 0.40% on the cost of debt. Therefore, the company business plan contains an allowed return on capital for the wholesale price controls of 3.16% - CPIH deflated (2.15% - RPI deflated).

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

We have allowed an uplift to the company's allowed return on debt of 33 basis points, equating to an allowed return for the wholesale controls of 3.11% (on a CPIH basis, 2.11% on a RPI basis). We set out the detail of our assessment supporting this decision in our 'Allowed return on capital technical appendix – A1'.

Consistent with the approach taken for other companies receiving a company-specific adjustment in draft and final determinations, we assess notional financeability on the basis of the sector allowed return on capital. We discuss our financeability assessment in section 5.2

The PR19 methodology confirmed we are transitioning to CPIH as our primary inflation index from 2020. At 1 April 2020, we will index 50% of RCV to RPI; the rest, including totex that is added to the RCV, will be indexed to CPIH. Table 4.6 and table 4.7 set out the opening and closing balance for each component of RCV as of 1 April 2020 and 1 April 2025 respectively.

The PR19 methodology confirms our protection of the value of the RCV as at 31 March 2020 across each of the wholesale price controls. This applies to the RCV that is defined as 'RPI inflated RCV' and 'CPIH inflated RCV' in tables 4.6 and 4.7; this RCV is run-off (or amortised) over time. Totex that is added to the RCV from 1 April 2020 is stated as 'post 2020 investment'.

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

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

	Water resources	Water network plus	Total
RPI inflated RCV	6.8	179.1	186.0
CPIH inflated RCV	6.8	179.1	186.0
Other adjustments	-	-	-
Total RCV	13.6	358.3	371.9

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

	Water resources	Water network plus	Total
RPI inflated RCV	3.2	124.2	127.4
CPIH inflated RCV	2.9	135.4	138.3
Post 2020 investment	16.8	145.4	162.3
Other adjustments	-	-	-
Total RCV	**22.9**	**405.0**	**427.9**

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

	Water resources	Water network plus	Total
RPI inflated RCV	0.5	15.9	16.4
CPIH inflated RCV	0.7	24.3	25.0
Post 2020 investment	1.5	12.5	14.0
Other adjustments	-	-	-
Allowed return on capital	**2.8**	**52.6**	**55.4**
Company (April 2019) – return on capital	2.8	58.5	61.2

Note allowed return on capital is calculated by multiplying the annual average RCV for each element of RCV (RPI inflated, CPIH inflated and post 2020 investment) by the wholesale WACC for each control. The allowed return on capital for each year of the price control for each wholesale control is shown in the 'South Staffs Water - Allowed revenue appendix' in tables 4.1 and 4.2.

4.2.4 RCV run-off

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

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

	Water resources	Water network plus	Total
CPIH inflated RCV	3.9	43.7	47.6
RPI inflated RCV	3.9	61.9	65.8
Post 2020 investment	2.3	22.2	24.4
Total RCV run-off	**10.0**	**127.8**	**137.8**

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

For the draft determination, we applied South Staffs Water's RCV run-off rates which recover an amount equivalent to current cost depreciation within each wholesale control. South Staffs Water does not make any representations in relation to RCV run-off rates and we continue to apply the company's RCV run-off rates for the final determination.

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

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

	Water resources	Water network plus
Company (April 2019) (%)	10.05%	6.36%
Draft determination (%)	9.97%	6.36%
Final determination (%)	9.71%	6.39%

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

The annual rates for each wholesale control are set out in the 'South Staffs Water - Allowed revenue appendix' in table 5.1 and table 5.2. Changes to totex allowances and PAYG rates for individual years can result in small changes to the average RCV run-off rates presented in the table above.

4.3 PR14 reconciliations

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

We are also applying adjustments to reflect performance in the final year of the 2010 to 2015 period, which could not be fully taken into account in PR14, and the inflation correction to the RCV from the capital expenditure incentive scheme (CIS). These adjustments apply to the RCV (the 'midnight adjustment') and revenue for the 2020-25 period. These adjustments are made in line with the 'PR14 reconciliation rulebook'.

We are publishing models for each of these reconciliations, and for the overall RCV and revenue adjustments on our website. 'South Staffs Water - Accounting for past delivery final decisions' provides a detailed explanation of all policy interventions we are making in the models. Table 4.11 summarises our interventions. Table 4.12 sets out the resulting adjustments to revenue and the RCV. The 'South 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 4.5.

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

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

However, most outcome delivery incentives for the 2020-25 period are in period and will have been reconciled before this date. In light of this we consider it would be more appropriate to complete this reconciliation in the autumn of 2020 and apply any change to bills for 2021-22 as part of the new in-period process. We are designating all of the financial PR14 performance commitments as being in-period for this purpose. Any adjustment between the 2019-20 forecast and actual figures should be modest and we do not expect a significant impact on bills. If, contrary to expectations the bill impact is more significant, we expect companies to take measures to smooth the impact for their customers. The new PR19 mechanism to share benefits with customers from unexpected high outcome delivery incentive payments in a year will not apply to PR14 outcome delivery incentives. Instead the PR14 protection that caps the impact across the five years 2015-20 will apply.

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

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

Incentive	Intervention(s)
Outcome delivery incentives	No interventions required.
Residential retail revenue	We are intervening to 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 change the total residential retail revenue payment at the end of the 2015-20 period which remains at £1.196 million.
Wholesale revenue forecasting incentive mechanism	We are including the elements of South Staffs Water's claim related to the demand for new connection and the cost of connections consistent with the updated value provided in the company's representation. We are excluding the elements of the claim not related to the variance in the volume of new connections as these are outside of the mechanism's scope. We explain our assessment in detail in 'South Staffs Water - Accounting for past delivery additional information.' Overall, our intervention increases the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from the company's estimate of the mechanism's impact of - £2.057 million to - £9.154 million.
Totex	We are intervening to change the 'Water: Final menu choice' figure to full decimal accuracy as calculated in the PR14 populated final determination models. Our intervention reduces the water totex RCV adjustment from £0.657 million to £0.639 million and reduces the water totex revenue adjustment at the end of the period from £0.069 million to £0.060 million.

Incentive	Intervention(s)
Land sales	No interventions required.
Residential retail service incentive mechanism	We are intervening to set South Staffs Water's residential retail service incentive mechanism adjustment to +2.07% of residential retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to +£1.605 million in total revenue over the period. This increases revenue relative to the company's estimate of the mechanism's impact and is driven by updating our analysis to take account of companies' finalised scores for 2018-19.
PR09 blind year adjustments	No interventions required.

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

Incentive	RCV adjustments		Revenue adjustments	
	Company view[1]	Ofwat view[1]	Company view[1]	Ofwat view[1]
Outcome delivery incentives	0.0	0.0	2.6	2.6
Residential retail revenue	N/A	N/A	1.2	1.2
Wholesale revenue forecasting incentive mechanism	N/A	N/A	-2.1	-9.2
Totex	0.7	0.6	0.1	0.1
Land sales	0.0	0.0	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	0.0	1.6
PR09 blind year adjustments[2]	-7.9	-7.9	-0.1	-0.1
Water trading	N/A	N/A	0.0	0.0
Other adjustments	N/A	N/A	N/A	0.0
Total	-7.2	-7.2	1.7	-3.8
Total post profiling[3]	**N/A**	**N/A**	**1.8**	**-4.0**

[1] The company view is based on data from the 15 July 2019 company submissions. It does not reflect impacts of the subsequent representations. The Ofwat view is based on the 15 July 2019 company submissions and takes account of representations and any interventions we are making.
[2] PR09 blind year adjustments includes the CIS RCV inflation correction. We show these separately in 'South Staffs Water - Accounting for past delivery appendix'.
[3] Total post profiling is the total revenue over the period, taking account of the time value of money and the company's choices of how it wishes to apply revenue adjustments either in the first year or spread over a number of years.

4.4 Other allowed revenue

Other components of allowed revenue are:

- The fast track reward, where applicable;
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the final determination.
- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments.
- Non-price control income – this forecast income is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control.

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

	Water resources	Water network plus	Total
Fast track reward	0.0	0.0	0.0
Tax	0.4	0.8	1.2
Grants and contributions (price control)	0.0	37.5	37.5
Deduct non-price control income	0.0	-9.2	-9.2

4.4.1 Taxation

We calculate a tax allowance reflecting the corporation tax that the company expects to pay in 2020-25. We calculate the tax allowance using our financial model based on the projected taxable profits of the appointed business and the current and enacted UK corporation tax rates and associated reliefs and allowances as at 30 September 2019. Any future changes to tax rates and allowances will be taken account of in the tax reconciliation model, further details are set out in the 'Aligning risk and return technical appendix'.

South Staffs Water provided information in data tables relevant to the calculation of the expected tax charge. As we apply the same tax information to our final determination as used for the draft determination, any movement in the resulting tax allowance is driven by differences in

taxable profits, which are as a result of our interventions in other areas.

Our draft determination required the company to provide further evidence to explain the scope of the third party review that was undertaken on its tax forecasts and the outcome of the work. South Staffs Water did not provide any evidence of assurance as no formal engagement was undertaken. Whilst the company has not provided sufficient evidence to demonstrate that its approach to assurance was reasonable, on the grounds of materiality of the tax allowance we take no further action for the final determination. We are currently developing our approach to the assurance of data and information for the next price control period and will provide more details in early 2020.

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

	Water resources	Water network plus	Total
Tax	0.4	0.8	1.2

4.4.2 Grants and contributions

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

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

Grants and contributions (price control)

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

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

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

Table 4.15 below shows our assumed amounts of 'gross' grants and contributions (price control) that is used to calculate net totex for cost sharing. This includes a one-off contribution of £10.5 million South Staffs Water did not originally include within grants and contributions in its business plan:

- Contribution from Severn Trent Water for a share of the expenditure at Hampton Loade water treatment works, as South Staffs Water describes in its business plan.

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

	Water resources	Water network plus	Total
Grants & contributions (before deduction of income offset allowances)	0.0	54.7	54.7

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

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

	Water resources	Water network plus	Total
Grants & contributions (price control)	0.0	37.5	37.5

Grants and contributions (non-price control)

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

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

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

	Water resources	Water network plus	Total
Grants & contributions (non-price control)	0.0	13.6	13.6

4.4.3 Non-price control income

Non-price control income is income from the excluded charges defined in licence condition B. For example, it includes bulk supplies, standpipes, unmeasured cattle troughs, and other services. For the final determination we confirm that diversions which are not requested under section 185 of the Water Industry Act 1991, for example, works under the New Roads and Street Works Act 1991 or those associated with High Speed 2, are also excluded from the price control. These are capital contributions and so do not get shown in tables 4.1 and 4.18.

This is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control. We have reviewed the company forecast of 'non-price control income' and use this in the final determination.

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

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

Note negative numbers represent a deduction from the allowed revenue.

4.4.4 Uncertainty mechanisms

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

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

- There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material.
- Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices.

We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for South Staffs Water along with all other companies serving England[7] because:

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

In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst receiving appropriate protection against material cost

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

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

5 Risk analysis and financeability

Key changes from the draft determination

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

- For the final determination, we apply our view of a sector risk range for totex, C-Mex, D-Mex and financing costs (including embedded debt) as part of our assessment of risk ranges for our final determination. We also apply updated views on risk ranges for outcome delivery incentives, determined under our Outcomes Framework.
- We revise our base notional dividend yield for the sector to 3.00% (from 3.15% in the draft determination) with dividend growth of 1.18%. This takes account of the allowed cost of equity in the final determination. For South Staffs Water we restrict the base dividend yield to 2.16% in our notional financeability assessment due to the high level of RCV growth in the final determination.
- We revise our approach to pension deficit recovery costs in our financial modelling of the notional company to match cash out flow for pensions deficit recovery costs to the allowed funding.
- For the final determination we advance allowed revenue by £0.77 million to ensure our determinations are financeable on the basis of the notional structure.

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

South Staffs Water is responsible for ensuring it delivers its obligations and commitments in the context of its choice of capital and financing structure. South Staffs Water may need to take further steps to improve its financial resilience. We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25.

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

5.1 Risk analysis

The PR19 methodology set out that we expect companies to demonstrate a clear understanding of financial risk to the delivery of their business plans and to explain and demonstrate how they manage and mitigate that risk. It required companies to use return on regulatory equity (RoRE) analysis to assess the impact of upside and downside risk on the basis of their notional capital structures based on a prescribed suite of scenarios using the company's assessment of P10/P90 confidence limit values[8].

RoRE is calculated as the return on equity for the equity portion of the RCV based on our notional gearing assumption. A company's base RoRE is aligned with our allowed real post-tax cost of equity, but it can differ between companies because the blended real cost of equity will vary according to the proportion of the RCV (and notional regulatory equity) that is indexed to RPI or CPIH[9]. The proportion of RCV (and notional regulatory equity) that is linked to RPI or CPIH varies between companies according to factors that include the size of the investment programme, the proportion of totex that is capitalised and RCV run-off rates.

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

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

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

[8] 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.

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

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

South Staffs Water has a significant scope to earn upside from outperformance as well as the risk of lower returns from underperformance with modest negative skew overall to its overall risk range, driven primarily by outcome delivery incentives. Our view is that an efficient company should be able to achieve the base return on the notional structure. The onus is on companies to manage the risk and effect of any downside scenarios while maintaining financial resilience.

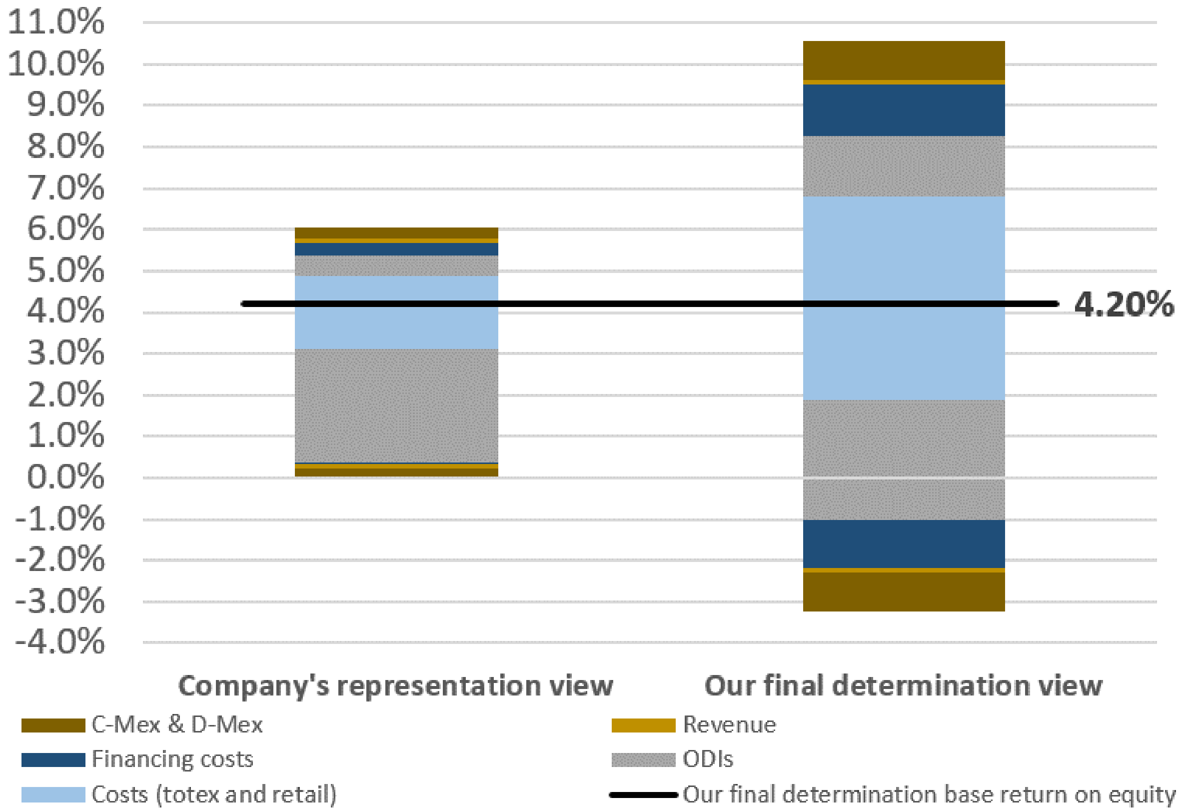
We asked companies to update their risk ranges in their representations. We state those risk ranges in table 5.1 against the cost allowances and base return on regulatory equity in our final determinations. These risk ranges are not fully comparable with our final determination ranges as they take account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

Table 5.1: South Staffs Water final determination risk ranges

	Range implied in company representation		Final determination ranges	
Base RoRE	-		4.20%	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-0.87%	0.36%	-2.12%	2.27%
Outcome delivery incentives	-2.74%	0.47%	-2.90%	1.46%
Financing costs	-0.05%	0.31%	-1.16%	1.23%
Retail costs	-0.21%	0.33%	-0.22%	0.33%
C-MeX and D-MeX	-0.24%	0.27%	-1.75%	1.35%
Revenues (includes Retail)	-0.11%	0.11%	-0.11%	0.11%
Total	**-4.23%**	**1.84%**	**-8.26%**	**6.75%**

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

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



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

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

- The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination.
- The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt.
- The outcome delivery incentive risk range has been determined under our Outcomes Framework as set out in table 2.4.
- The C-MeX risk range is calculated as 12% upside and 12% downside of Residential Retail Revenue, reflecting the cap and collar limits for this incentive.
- The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.

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

5.2 Financeability

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

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

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

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

Our PR19 methodology requires companies to provide Board assurance that the business plan is financeable on both the notional and their actual capital structures and requires companies to provide evidence to support these statements, including evidence supporting the target credit rating and that this is supported by the financial ratios that underpin the plan.

In its April business plan, South Staffs Water sets out that its 'business plan is financeable on both the notional and actual capital structure and that the plan protects customers' interests in both the short and the long term'. The company states that its plan targets a credit rating of Baa1 on a notional basis.

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

In its representations to the draft determination, South Staffs Water sets out that the Board does not consider that Ofwat has fulfilled its legal duties to allow it to finance its functions and the Board is unwilling to certify that the draft determination is financeable for either its actual or notional structure. South Staffs Water provides qualified assurance stating that if the representations on the draft determination are accepted in their entirety, the company will remain financeable on both an actual and notional basis.

In the context of the lower allowed return in the draft determinations than its business plan, South Staffs Water makes a representation for a company-specific increase to the cost of debt in its allowed return on capital, proposing an uplift of 40bps of the overall cost of debt.

The Board assurance statement sets out that if there is any significant further reduction in the allowed return, it may not allow the company to maintain further financial resilience in either the actual or notional structure and it would therefore require a further increase in a company-specific cost of debt uplift or an adjustment to the PAYG rate to accelerate revenue.

We have carefully considered the representations made by South Staffs Water including the qualifications on the assurances provided. We have considered this in the context that the allowed return which is based on market data is lower than our draft determination and the basis on which the company provided assurance about the financeability of its plan. However we are satisfied that the market data supports our view that allowed returns are sufficient to reward investors for the risks they face in a sector that already benefits from significant risk protections[10]. South Staffs Water passes the three stage assessment for its requested company-specific adjustment to the allowed return and we apply an increase equating to 33 basis points to the

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

allowed cost of debt which is based on our own calculations. We set out the revisions we are making to our performance commitments and cost allowances elsewhere in this document. We consider the revenues allowed in our final determination, which reflect our assessment of efficient allowed costs, are sufficient for South Staffs Water to meet its obligations and commitments to customers on the basis of the notional structure. We comment on the financial resilience of the actual structure in section 5.3.

We apply the company-specific adjustment to the allowed cost of debt after our financeability assessment as the adjustment is made on account of circumstances specific to the company and its performance, and is consistent with the approach we took in the draft determination for other companies where an adjustment was made.

In its representations, South Staffs Water sets out that its financeability concerns are linked to adjustments not accepted as part of the reconciliation adjustment for the wholesale revenue forecasting incentive and it considers the financeability assessment should take into account in-period outcome delivery incentive performance adjustments. Consistent with the PR19 methodology, the financeability assessment in our determinations is carried out before reconciliation adjustments so as not to dilute regulatory incentive mechanisms on companies, the effects of which must be managed by companies and their investors. We consider that South Staffs Water, if efficient, is able to meet its obligations and commitments to customers set out in its final determination within the efficient cost allowance we set. However we do comment on the headroom in the financial ratios for the notional capital structure below.

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

RCV growth in South Staffs Water's final determination exceeds 10%. Therefore consistent with our policy approach set out in 'Aligning risk and return technical appendix' we consider it is appropriate for equity to contribute to the funding of this growth. In our financeability assessment we restrict the base dividend yield to target gearing around the notional level of 60% in 2025, consistent with the gearing level that underpins the calculation of our allowed return. The resulting dividend yield we assume is 2.16% with dividend growth of 1.18%.

In table 5.2 we set out some of the financial ratios provided by the company in its business plan, and in our draft and final determinations. Our financial modelling of the notional company for the final determination suggests that South Staffs Water faces a financeability constraint. Consistent with the approach in the PR19 methodology, our final determination increases PAYG rates to bring forward £0.77 million of revenue to improve cash flows and financial ratios in 2020-25. The financial ratios stated in table 5.2 include the effect of the increase to PAYG rates. We note that certain financial ratios for the final determination are lower than set out by South Staffs Water in its business plan. We removed South Staffs Water's PAYG adjustment in the draft determination. The nominal bill profile proposed in the business plan resulted in a need for revenue to be advanced to improve financial ratios which we did not accept in our draft determinations. Following the subsequent uplift to PAYG rates in the final determination average adjusted interest cover is broadly in line with other companies in the sector and the funds from operations to net debt ratio is significantly higher than the sector average.

Our in the round assessment of notional financeability is made on the basis of the financial ratios from our financial model. It takes account of the evidence that the company provides regarding the levels and thresholds of the financial ratios that underpinned its assurance statement on the notional financeability in its business plan (also stated in table 5.2). We note that the Board assurance statement that accompanied the company's representations was made in the context of the draft determination. Our assessment of notional financeability for the final determination is made in the context of changes made in our final determination. We consider that South Staffs Water's final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.

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

	Business plan	Draft determinations	Final determinations
Gearing	61.06%	61.46%	60.45%
Interest cover	4.90	4.90	5.04
Adjusted cash interest cover ratio (ACICR)	1.85	1.66	1.50
Funds from operations (FFO)/Net debt	13.95%	13.04%	12.69%
Dividend cover	2.74	1.34	1.97
Retained cash flow (RCF)/Net debt	12.79%	11.17%	11.35%
Return on capital employed (RoCE)	4.75%	4.16%	4.03%

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.

South Staffs Water sets out in its representations that the Ofwat financial model overstates the adjusted interest cover financial ratio, principally due to the treatment of pension deficit recovery payments. We correct the treatment of pension deficit in the financial ratios for the final determination which lowers the financial ratios compared with out draft determination. We discuss this issue further in the 'Aligning risk and return technical appendix'.

We set out the average PAYG and RCV run-off rates along with the RCV growth over 2020-25 for South Staffs Water in table 5.3. RCV growth for the final determination is lower than in the company's April plan and in the draft determination. Overall, changes to allowed expenditure, the revised approach to determining the mix of operating and capital expenditure and the removal of the uplift to PAYG rates proposed in the April plan means that there is less expenditure added to RCV. We are not amending South Staffs Water's RCV run-off rates.

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

	PAYG	RCV run-off	RCV growth
Company April 2019	61.3%	6.52%	19.75%
Draft determinations	57.5%	6.52%	20.26%
Final determinations	63.5%	6.55%	15.06%
The PAYG and RCV run-off rates are averages across five years and across all wholesale controls. We set out the changes we make to PAYG and RCV run-off rates along with the five year average for each control in section 4.2 and annual PAYG and RCV run-off rates in the 'South Staffs Water - Allowed revenue appendix'. Changes to totex allowances and PAYG rates for individual controls can result in small changes to the average RCV run-off rates presented in the table above.			

In assessing the financeability of the notional company, we consider the headroom available in the final determination to allow the company to continue to meet its annual interest costs. We estimate 5 year headroom of £18 million above an adjusted cash interest cover of 1.0 times, against our totex downside of £20 million and outcome delivery incentives downside of £8 million calculated as 1% return on regulatory equity. We note that South Staffs Water has the highest RCV run-off rate for the sector, we have advanced revenue for the company to meet a financeability constraint and the company has a PAYG rate that is higher than average for the sector, therefore we are not persuaded that further intervention is necessary to increase headroom for the company. We set out further detail in relation to our approach to assessing headroom within final determinations in the 'Aligning risk and return technical appendix'.

5.3 Financial resilience

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

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

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

South Staffs Water reported gearing of 70.6% as at 31 March 2019, it expects to reduce its gearing so that it remains below 70% in 2020-25. Its plan forecasts gearing of 67.5% at 31 March 2021 and 69.6% in at 31 March 2025. The company has confirmed it has secured the repayment of a £15 million loan which it had made to another group company which it says will provide additional financial headroom.

At the time of our final determination the company has a credit rating of Baa2 (negative) with Moody's and BBB+ (negative) with S&P.

The South Staffs Water Board provided assurance that it considered the company to be financially resilient under its plan. The Board assurance in its representation set out a company-specific adjustment to its allowed return or further revenue advancement was necessary if we set a lower allowed return in the final determination.

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

However, we have not accepted all of the company's representations. The allowed return is lower in the final determination reflecting market expectations on the cost of finance. We have allowed South Staffs Water a company-specific adjustment to its return and we have introduced company-specific collars on outcome delivery incentive exposure. However, the company may need to take further action to maintain its financial resilience.

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

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

In its future reporting, we expect the company to explain clearly in its long-term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks. South Staffs Water has committed to assess its financial resilience beyond 2025 in its next long-term viability statement.

6 Affordability and bill profile

Key changes from the draft determination

- We have made no key changes to South Staffs Water's final determinations as the company's average bill profile at draft determination already included a gradual reduction to provide a flat nominal bill.

6.1 Bill profile

South Staffs Water proposes an average bill profile with an 8.9% reduction. Our bill profile provides a greater reduction of 10.3% over 2020-25. South Staffs Water does not submit additional evidence on bill profiles or acceptability in its representation but its customer challenge group makes a representation in this area, stating that we should respect customer wishes and provide customers with the flat nominal bill that they supported in the company's testing.

As we stated at draft determination, we are not facilitating the flat nominal bill in the way the company asked for because we consider it to be in customer interests that out- and underperformance payments are aligned closely to the performance that led to them rather than being stored up to the end of the period. We do not accept that in-period adjustments need lead to a genuine increase in bill volatility. A flat nominal bill approach would mean customers having an inflated bill early in the period to cover the expected costs of inflation later on. Further, we consider that the company's proposal could lead to an unnecessary step change in bills in 2025-30, which we aim to avoid.

While not accepting the company's method to keeping nominal bills flat, we do accept the case for it having a flat nominal terms bill profile (as we did for it at draft determination) and have followed this approach for its final determination. Across the industry, we have adopted a flat nominal bill profile wherever possible, for the following reasons;

- Research shows customers want consistent, predictable bills;
- Flat nominal bills will help households, particularly those who are financially vulnerable, to plan their finances;
- Profiling in this way is easy to understand and communicate to customers;
- Profiling bills in this way has extensive support from stakeholders including water companies, customer challenge groups and the Consumer Council for Water;

- Company revenues fall less sharply in 2020 with a gradual bill reduction, reducing impact of any step change in allowances.

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

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company April 2019	£140	£138	£135	£133	£130	£128
Draft determinations	£140	£125	£122	£120	£118	£116
Final determinations – before reprofiling	£140	£136	£133	£131	£128	£127
Final determinations	£140	£136	£134	£131	£128	£126

Throughout the price control we have put a strong emphasis on companies planning for the long-term, both in terms of their goals and their bills. Following actions we set out at initial assessment of business plans, nine companies including South Staffs Water undertook additional customer testing on their long-term bill profiles with several making adjustments as a result. We expect companies to continue to pay attention to this issue, taking customer views into account and planning in a way that ensures they control costs into the future.

6.2 Help for customers who are struggling to pay

Our final determinations for South Staffs Water will deliver a real terms reduction of 10.3% 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 (PSR) common performance commitment and their bespoke affordability and vulnerability performance commitments to us and their customers on an annual basis during the price control period. In addition, companies put forward in their business plans further measures for addressing affordability and vulnerability issues. We expect companies to report periodically to their customers on their progress in addressing affordability and vulnerability concerns. We will also be considering how we will scrutinise and report on companies' progress in this important area, including working with other stakeholders in the water sector and beyond.

6.3 Total revenue allowances and k factors

Table 6.2 summarises the allowed revenue for each control. This is expressed in a 2017-18 CPIH price base so that this can be compared with the rest of this document.

Table 6.2: Allowed revenue by year (£ million, 2017-18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water resources	9.2	9.3	9.7	9.9	9.7	47.8
Water network plus	105.3	104.6	103.3	97.1	95.9	506.2
Residential retail	13.0	12.9	12.8	12.7	12.6	64.0
Total	**127.5**	**126.8**	**125.8**	**119.7**	**118.2**	**618.0**

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

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

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

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

	Base (£m)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	9.2	0.00%	1.56%	3.94%	2.25%	-2.01%
Water network plus	105.3	0.00%	-0.68%	-1.19%	-6.11%	-1.23%

7 Putting the sector in balance

Key points

- South Staffs Water is reported gearing of 70.6% as at 31 March 2019. South Staffs Water forecasts that its level of gearing (67.5% by 2021 and 69.6% by 2025) will be close to triggering sharing payments under the gearing outperformance sharing mechanism in 2020-25, as set out in the 'Aligning risk and return technical appendix'. We are updating the gearing outperformance sharing mechanism to introduce a glidepath to the gearing level that the triggers sharing payments as set out in the 'Aligning risk and return technical appendix'.
- We have not accepted the company's proposal that its own definition of gearing should be used for the calculation of benefit sharing would deliver equivalent benefits for customers in the round.
- Consistent with the lower allowed return on equity in our final determination, we are revising our calculation of the dividend yield as a guide to the reasonable base dividend yield in the absence of out/underperformance in 2020-25. We set out that the acceptable level of base dividend yield can be expected to vary depending on the scale of a company's RCV growth in 2020-25 and future investment needs.
- On executive pay, South Staffs Water exceeds the 60% alignment to delivery for customers we identify as current good practice. We retain our expectation of the company that it will ensure its dividend and performance related pay policies demonstrate substantial alignment with the customer interest, underpinned by stretching performance levels throughout 2020-25.

In July 2018 we published our 'Putting the sector in balance: position statement'. The position statement sets out the steps we expect companies to take to demonstrate they strike the right balance between the interests of customers and their investors. In summary, we expect that:

- company dividend policies for actual financial structures and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers[11];
- companies with high levels of gearing share financing gains from high gearing with customers; and

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

- companies provide assurance and supporting evidence to demonstrate their long-term financial resilience and management of financial risks for the actual financial structure, taking account of their future investment needs.

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

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

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

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

Our assessment of the company's proposals to balance the interests of customers
Gearing outperformance benefit sharing mechanism In its representation, the company sets out it disagrees with the mechanics of our default mechanism and proposes the same adjustment to gearing which was rejected at draft determination. South Staffs Water proposes to use its covenanted gearing rather than the regulatory gearing reported in the annual performance report. The company considers its definition of gearing reflects the true liability of the company and using the regulatory gearing could impact on its credit rating. We consider South Staffs Water's definition for gearing is specific to its own financing arrangements and is a matter for the company and its investors. Their definition is inconsistent with the definition of gearing in the Regulatory Accounting Guidelines (RAGs). South Staffs Water has not provided convincing evidence that its proposed alternative mechanism would deliver equivalent benefits for customers in the round to our mechanism.
Voluntary sharing mechanisms 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.
Dividend policy for 2020-25 South Staffs Water confirms that it is committed to meet the expectations on dividend policy as set out in our 'Putting the sector in balance' position statement. In doing so its representations indicate an average gross base dividend yield of 3.1% over 2020-25 (2% after netting off inter-company loan interest income). The company's dividend policy refers to all the areas included in the 'Putting the Sector in balance' position statement (out/underperformance & benefit sharing, employee interest & pension obligations, actual capital structure, need for future investment and financial resilience). The company confirms that when setting dividend payments, it will take into consideration its actual performance in relation to regulatory and customer targets (principally delivered through performance commitments). It has detailed the specific obligations and commitments to customers that will be considered and confirms that the level of performance delivery considered will be

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

determined with reference to the final determination. It confirms that dividends can be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid.

The company commits that it will publish its dividend policy each year, highlighting any changes to customers and other stakeholders. It will also report retrospectively on dividend payments, cross-referencing its dividend policy so that customers and other stakeholders can understand the rationale.

Consistent with the lower allowed cost of equity in our final determination, we have revised our calculation of the dividend yield that we consider to be reasonable for assessing the base dividend for water companies in 2020-25. We consider the acceptable level of base dividend yield is up to 4% but this can be expected to vary depending on the scale of a company's RCV growth and future investment needs. We set out further details in 'Aligning risk and return technical appendix'.

We expect South Staffs Water to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25, to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in the final determination 'Aligning risk and return technical appendix'.

Performance related executive pay policy for 2020-25

In our 'Aligning risk and return technical appendix' we identify that 60% alignment to delivery for customers is current good practice among the companies that we regulate. Based on our calculations, South Staffs Water's measures that are directly aligned to customer delivery exceeds good practice, however we consider that there is scope for it to improve this position. We expect South Staffs Water's policy on performance related executive pay to demonstrate a substantial alignment to the delivery of service for customers throughout 2020-25.

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 will be derived from customer service objectives (including C-Mex, D-Mex and complaints)
  - one third will be derived primarily from performance arising from the standard outcomes for the sector (leakage, supply interruptions, compliance risk index, PCC, mains bursts, unplanned outages and employee safety)
  - one third financial performance (including profit, cash generation, totex performance and cost efficiency).
- targets for the annual scheme will initially be calibrated against the final determination. During 2020-25 the remuneration committee will monitor the level of stretch within the targets with reference to upper quartile sector performance, and targets will be modified as necessary to ensure they remain appropriate and challenging.
- the long-term scheme is still be designed, but will be completed before April 2020, and will include key elements of customer service, outcome delivery incentives and financial performance. Targets will be calibrated against the final determination and reviewed each year with reference to the upper quartile level for the sector.
- 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 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.

Our assessment of the company's proposals to balance the interests of customers
• a commitment to full transparent reporting in the annual performance report, including any changes to the policy and the underlying reasons for the change. The company will publish its policy on its website along with the initial performance targets in early 2020, and in any event, ahead of 1 April 2020. We expect the company's remuneration committee to ensure there is on-going rigorous challenge as to how the policies are applied and to ensure that only truly stretching performance is rewarded. In so doing, we expect it to be equipped with the appropriate powers to carry this out, including for example, the use of withholding periods, clawback arrangements and underpin / gateway arrangements. We expect South Staffs Water to be transparent when explaining and reporting against its performance related executive pay policy in 2020-25, to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in the final determination 'Aligning risk and return technical appendix'.

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

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