Business plan

Representation following Ofwat's draft determination

October 2014

sembcorp
bournemouth water

Contents of draft determination representation

Chapter

1. Overview

Introduction

Key points

- The draft determination sets a very challenging period for the company and Ofwat has not allowed a number of very important costs, which cumulatively, have a significant impact on the business. In addition, Ofwat's approach to materiality thresholds is unrealistic and disproportionally penalises small companies
- We have serious concerns regarding the approach taken to setting revenues for our household retail business, particularly the exclusion of any allowance for inflation.
- Metering on change of occupier is a successful, long-term policy which contributes significantly to Government targets to reduce per capita consumption; and results in reduced leakage. Although we accept this and have revised our plan, we view Ofwat's decision to not allow funding as taking a short-term approach and not in the best long-term interests of customers or the environment.
- We consider Ofwat's failure to fund the costs of meeting a statutory obligation to undertake works to achieve the National Environment Programme to be inconsistent with its own statutory duties.
- The company will face a real challenge to meet a key customer expectation to reduce leakage as a result of the relatively modest costs not being allowed.
- We accept some challenges relative to our business plan and offer solutions to a number of problems we perceive with the draft determination.

Ofwat's draft determination of our prices for 2015-2020 was published on 29 August 2014.

We welcome recognition of the cost of debt for small companies and present evidence here that customers are willing to pay a small amount for the value they derive from being served by a small company.

The treatment of retail costs in the draft determination is not appropriate. Cost inflation exists in every industry. The extent to which this is passed on to customers is a function of a company's competitive and efficiency position. The more efficient the company, the lower will be its ability to absorb costs. While the retail business experienced some exceptional cost increases in 2013/14, our retail activities have consistently been regarded as being at the forefront of efficiency and service.

We expect general input price inflation on the retail business of 2.5% per annum from 2013/14 to 2019/20, primarily in the form of labour costs which account for 57% of total costs in the business. We believe efficiencies can absorb 1.21% of this. It is consistent with Ofwat's statutory duties that the residual 1.29% is allowed for in price limits.

We cannot accept the outcome of the determination on the basis of Ofwat's approach as this would result in our retail business being unsustainable.

The reduction in the PAYG rate to 75% creates unstable bills in the longer term which goes against our customers' wishes. Further research confirms customers' significant preference for bill stability over 10 years and as such we ask that Ofwat review their approach to our proposed ratio. The Customer Engagement Planning Forum supports our approach.

We welcome the funding for additional water mains replacement, which will help narrow the gap between current and optimum replacement levels.

We acknowledge the cost assessment adjustment for the atypical cost of supplying our large special agreement customer.

We are disappointed at Ofwat's decision not to allow funding for the continuation of our successful programme of metering on change of occupier, on the basis that we do not have a supply demand deficit. We view this as a short-term approach to a long-term issue and not in the best interests of either customers or the environment in the longer term. However, we accept the decision but request that Ofwat amend its cost models and our baseline submission to reflect this as a revised proposal.

We view the draft determination as extremely challenging. Our modelling indicates that the returns we will earn will be below Ofwat's view on the cost of capital. This is primarily due to Ofwat's approach to retail cost pressures. We request that Ofwat recognise the company's position in respect of the key areas detailed below.

Matters about which we make representation

We contest the following decisions on the basis that Ofwat has either misinterpreted our intentions, or that we disagree with the cost assessment modelling or logic employed.

1. **Retail Input Price Pressure (IPP)**

   Ofwat's logic in refusing our retail IPP claim is flawed and we present third party evidence to substantiate this statement. As a result of the third party work, we propose a reduced IPP claim.

2. **Retail HH control**

   We present evidence that without funding for net efficient input cost allowances, the household retail business is not financially viable.

3. **Pay As You Go Ratio**

   Customers have confirmed their preference for and even bill profile. We can broadly deliver this over 10 years using the PAYG ratio. We present the results of the customer research and a remodelled PAYG ratio.

4. **National Environment Programme - invasive species**

   We argue that, as an entirely new statutory obligation, introduced for PR14 by the Environment Agency, the cost for this cannot be included in the wholesale cost assessment models as they are backward looking. We therefore require full recognition of the cost without challenge, providing the evidence passes Ofwat's four assessment tests.

5. **National Environment Programme - catchment management**

   We present evidence to show that our planned activities will pass Ofwat's four assessment tests.

6. **Reduction in leakage**

   Ofwat's stance that the proposed cost is implicitly included in the cost assessment modelling is flawed, in that the work planned is atypical, is proposed as a direct result of customer research, will deliver what customers are expressly willing to pay for, and will pass the four assessment tests.

7. **Outcomes and ODIs**

   We request revision of a small number of ODIs and performance commitments following Ofwat's interventions and we propose amendments in respect of four commitments.

8. **The material impact of data inconsistency in cost assessment models**

   We present evidence of data inconsistency in the cost assessment modelling following the removal of selective metering (ie metering on change of occupier) from our plan. This would reduce the cost assessment gap by a material amount if corrected.

9. **Changes to the cost base**

   We summarise changes to our proposed cost base made in response to the draft determination and an independent third party review of our retail input price pressures.

Other items

Other requested information and details of ongoing customer engagement proposals are provided after the representation items at the end of the document.

We also summarise the revisions to our proposed cost base.

2. Board assurance statement

Introduction

The Board of Sembcorp Bournemouth Water assured the business plan submitted to Ofwat in December 2013, providing a comprehensive description of the processes that were adopted, the directors' involvement in the development of the plan, and challenges made. The Board further assured the company's June 2014 submission. Both statements remain valid and should be read in conjunction with this update.

Following the publication of Ofwat's draft determination the Board has been kept aware of the implications and how the executive team has proposed addressing these.

The Board has been involved in the company's assessment of Ofwat's modelling of costs and in its assurance statement for the June submission urged Ofwat to consider its risk-based review modelling. While in the Board's opinion it was fit for purpose for the initial risk-based review, in its June assurance statement the Board highlighted its concern that the modelling does not take account of the specifics of the company's business.

While the draft determination has recognised part of the company's argument the Board remains concerned that the modelling continues to under-represent actual activity levels. For example, the 'non-material' items not considered in the modelling becomes material when considered together.

In addition, the hurdles that have been set to obtain funding for a statutory obligation, the National Environment Programme, are also, in the Board's opinion, not appropriate.

Other hurdles have not always been as transparent as they could have been. For example, it has not been clear from the outset that the need for companies to demonstrate cost efficiency in retail was actually a requirement to demonstrate upper quartile performance. This has undermined the approach we have taken in our business plan submission.

The Board is very concerned at the challenge set by Ofwat in respect of managing the costs in the company's retail function. While the company may no longer be one of the most efficient operators in retail, to disallow any upward cost pressures is not appropriate.

The Board is also disappointed that the costs that the company has identified in respect of reducing leakage to a level consistent with what customers have supported and are willing to pay for have not been allowed, and that funding for the very effective programme of metering on change of occupier that has been a substantial part of a long-term strategy to manage water use for the past 14 years, will not be continued. However the Board accepts the decision on metering.

In relation to this representation, the Board is satisfied that additional engagement with customers has ensured that their views have been understood and taken into account in compiling this representation. All of the proposed revisions and additional evidence have been reviewed by an independent technical auditor and presented to the Board.

The Board is satisfied that it has been provided with sufficient information to enable it to conclude that this representation is consistent with the company's aims and objectives and that what customers want and are prepared to pay for is represented.

The Board urges Ofwat to reconsider its approach to the costs allowed for household retail, without which the function will not be sustainable.

On behalf of the Board

Roger Harrington

Managing Director

3. Representation 1

Household retail – input price pressures

Introduction

Key points

- The approach to efficiency and cost pressures has assumed a binary situation. In reality, cost pressures link to efficiency in a continuous manner.
- Two independent reports agree that we need to be allowed input price pressure (IPP) but not to the extent we have claimed in our December and June submissions. They agree that we need to apply challenging efficiencies.
- We accept a challenge to become more efficient but request that Ofwat allow an inflationary cost increase of 1.29% per annum rather than the 1.9% (net of efficiencies) we proposed in our June 2014 business plan submission.
- We understand that Ofwat has taken actual 2013/14 costs and deflated these to 2012/13 prices. For a revenue control in nominal prices, this is not appropriate and if a company's performance is assessed on the basis of its actual 2013/14 cost, with no indexation allowed up to 2020, the costs in 2013/14 must be used as the starting point.

In our June 2014 household retail submission, we made a claim for a cost adjustment relating to IPP, amounting to £2.7m across the period 2015-20. Following challenge by Ofwat, we engaged Oxera to carry out independent research on our IPP claim. The Oxera report supported the principle of an IPP claim, but challenged us to achieve efficiencies of 0.6%, reducing our claim from 2.5% to 1.9%. Oxera's efficiency was based on our frontier efficiency position in 2012/13.

Following the draft determination, another independent study was carried out by Economic Insight which also supports the principle of an IPP claim, but challenges us to achieve efficiencies of 1.21% per annum, recommending an IPP increase of 1.29%.

Our claim was assessed by Ofwat as having passed its assessment for:

- Materiality
- Being beyond efficient management control, and
- Value.

Ofwat accepted that we had:

(i) provided sufficient and convincing evidence with regard to our cost management practices; and

(ii) that our methodology for quantifying the size of the adjustment was appropriate.

However, our claim was rejected for the following reasons:

- Efficiency benchmarking

  While we had provided sufficient and convincing benchmarking evidence in relation to wage efficiency relative to other industries, we had not done so in other areas.

- Upper quartile performance

  Ofwat's assessment was that we were not upper quartile efficient with regard to either its household retail metered or unmetered costs and so failed a test for input price pressure eligibility.

We commissioned Economic Insight[1] to carry out further analysis to help address Ofwat's feedback. Their key conclusions are that:

- On a range of metrics, our retail cost to serve is low relative to other industries

- They consider it inappropriate for Ofwat to allow or disallow claims on the basis of whether or not a company is 'upper quartile' efficient.

- The company should make efficiency savings of approximately 1.21% per annum, but can justify an upward cost allowance of 1.29% per annum to fund unavoidable increases in costs.

Cost to serve relative to other industries

We are a high-performing company in terms of customer service and efficiency and we want to continue this high level of performance. To ensure this we need to attract and retain high quality people to deliver this. Economic Insight[2] points out that analysis by Oxera[3] on our behalf shows that labour and staff costs make up 57% of our costs. In other words, the evidence shows that in respect of the majority of the company's retail cost base (57%), Ofwat considered that the external benchmarking *was* sufficient and convincing.

The upper quartile test

Economic Insight challenges Ofwat's approach because inflation and efficiency are intrinsically linked, and both are on continua. Consequently, the most appropriate approach is to assess the net position of companies on both and to allow for net input price pressure accordingly, based on the available evidence. They conclude that such an approach:

(a) would reflect what one would expect to occur in a competitive market;

(b) is in line with economic theory; and

(c) would, by definition, mean that less efficient firms are required to absorb more inflationary pressure.

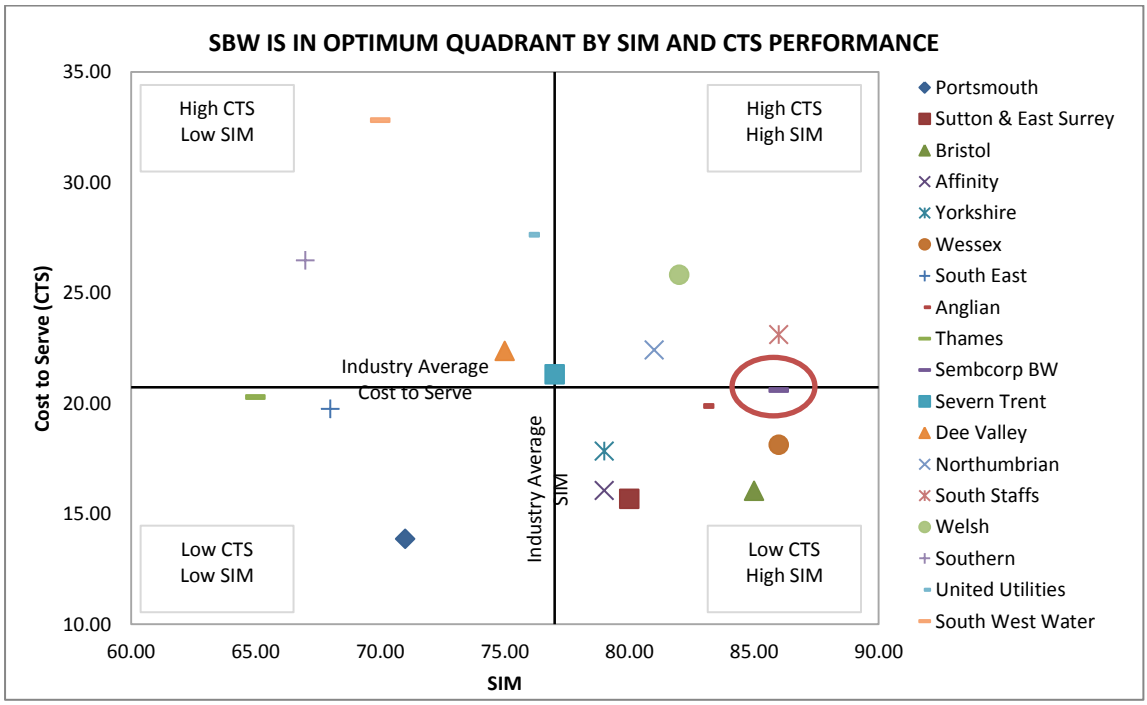
[1] Sembcorp Bournemouth retail IPP benchmarking – Economic Insight
[2] Page 2, Sembcorp Bournemouth retail IPP benchmarking – Economic Insight
[3] Oxera analysis of SBW adjustments to retail costs

However, we accept the argument put forward by Economic Insight that companies closer to the industry ACTS should be expected to absorb some inflationary pressures and not be awarded the full amount. Therefore we accept Economic Insight's recommendation[4] on the percentage proposed for IPP of 1.29% per annum over six years to 2019/20 compared with 1.9% per annum proposed, based on the numbers submitted in the business plan in June 2014 before taking account of efficiencies. The table below shows the impact on costs.

(£m)	2015/16	2016/17	2017/18	2018/19	2019/20	Total
IPP cost included in June submission	0.347	0.438	0.520	0.624	0.741	2.670
IPP cost claimed as part of this representation	0.109	0.164	0.220	0.277	0.334	1.104

We note that companies with a cost to serve above the average of the industry will be allowed to follow a glide path to reduce their costs to the average. We believe Ofwat should apply the same principle to IPP and efficiency.

We were not awarded IPP costs because we were not in the upper quartile of efficiency. In addition to the argument put forward by Economic Insight in their paper, we have reviewed the cost to serve of all companies and mapped it against the three-year SIM performance as published by Ofwat. The graph below maps this relationship which puts us in a unique quadrant of top SIM performance with low cost to serve suggesting an all-round measure of efficient performance and effective service.



[4] Page 9, Sembcorp Bournemouth retail IPP benchmarking – Economic Insight

Representation

We contest that the data submitted clearly demonstrates that our claim for IPP is valid and as a consequence, the revised claim of 1.29% per annum over six years to 2019/20 should be recognised.

We understand that Ofwat has taken actual 2013/14 costs and deflated these to 2012/13 prices. For a revenue control in nominal prices, this is not appropriate and if a company's performance is assessed on the basis of its actual 2013/14 cost, with no indexation allowed up to 2020, the costs in 2013/14 must be used as the starting point.

We cannot accept a revenue cap for the household retail part of our business that would not enable an efficient business to be viable.

4. Representation 2

Household retail – financeability

Introduction

Key points

- The allowed costs will not enable the company to run a financially viable retail business.
- The new costs which have not been allowed relate to a new billing system that was carefully researched to provide resilience, deliver improved service and meet the demands of the non-household retail market opening in 2017, for the whole business.
- To achieve a reasonable return and deliver continued excellent service, we require an IPP allowance of 1.29% per annum and the full amount of new costs of £1.200m.

Draft determination for household retail

Ofwat's decision on the household retail revenue limit for the company shows a deteriorating household retail business over AMP6.

This table shows the regulatory P&L for the household retail business using Ofwat's draft determination figures

£ nominal	*2013/14*	2015/16	2016/17	2017/18	2018/19	2019/20
Revenue		**4.595**	**4.699**	**4.790**	**4.815**	**4.595**
Opex	*4.184*	4.224	4.292	4.355	4.415	4.224
EBITDA		**0.371**	**0.407**	**0.435**	**0.400**	**0.371**
Depreciation		0.110	0.173	0.236	0.233	0.110
Interest		-	-	-	-	-
Tax		0.052	0.047	0.040	0.033	0.052
Net profit		**0.209**	**0.187**	**0.159**	**0.134**	**0.209**

While the business will be just profitable, the costs used by Ofwat are significantly less than what we expect to incur during AMP6, leaving the household retail business un-financeable in the short term, and unsustainable in the long term. We explain below why this is the case.

Costs not allowed by Ofwat

Ofwat has rejected all of our IPP claims from the 2012/13 year.

The additional costs that Ofwat has allowed (an increase in our G&S allocations from the wholesale business mainly relating to the new billing (CRM) system) have been capped as part of Ofwat's Materiality Threshold methodology.

The effect of these decisions on our allowed opex is shown in the following table.

All figures in £m nominal	2015-16	2016-17	2017-18	2018-19	2019-20	TOTAL
Total opex as submitted in the June 2014 submission	**4.682**	**4.841**	**4.991**	**5.017**	**5.194**	**24.725**
IPP costs not allowed	- 0.347	- 0.438	- 0.520	- 0.624	- 0.741	- 2.670
Costs above materiality threshold	- 0.120	- 0.120	- 0.120	- 0.120	- 0.120	- 0.600
Re-profile of pensions	- 0.060	- 0.060	- 0.060	0.080	0.080	-0.020
Other	- 0.000	0.001	0.001	0.002	0.002	0.006
Opex allowed by Ofwat (CTS excl depreciation)	**4.155**	**4.224**	**4.292**	**4.355**	**4.415**	**21.441**

Bearing in mind that our base cost in 2013/14 was £4.184m, we believe the level of cost increase that we are expected to absorb is unsustainable, and that an inevitable outcome will be that the excellent levels of service that we currently offer our customers will deteriorate.

Input price pressures

Representation 1 outlines our argument on input price pressures. We accept that no company is immune from efficiency savings. However, we do not think it possible for a company operating at a below average cost to serve to absorb all IPP for a period of six years as expected Ofwat.

We engaged Economic Insight, as detailed in Representation 1, to review our IPP requirements and arguments. In our June 2014 submission, we forecast inflationary cost pressures amounting to 1.9% of base costs per annum after we applied efficiencies. Economic Insight concluded that we could justify only 1.29% of our original IPP claim after modelling the company's relative position in respect of efficiency and applying a frontier shift. We accept this independent expert view, and the associated challenge to drive further

operational efficiencies in the business mainly through staffing efficiency, process innovation and efficiency, and electronic innovation such as electronic billing activity.

This means that we now request recognition of inflationary costs of £1.104m, which is around 60% less than we requested in our June 2014 submission. We agree with the conclusion of the two independent experts that it is not appropriate to ignore all inflationary pressures for any company that is not currently considered to be in the upper quartile of an efficiency ranking.

We propose the following revised IPP claim:

(£m)	2015/16	2016/17	2017/18	2018/19	2019/20	Total
IPP cost claimed as part of this representation	0.109	0.164	0.220	0.277	0.334	1.104

New costs above the materiality threshold

Ofwat has stated that the new costs we have been allowed are above what can be explained by increasing customer numbers, and above Ofwat's notional 2.25% materiality threshold. The increase in costs is due to the following factors:

1) Reallocations from the wholesale business and depreciation of assets purchased post 1 April 2015.

   We explicitly followed Ofwat's guidelines on cost allocation. However, the sum of currently incurred costs excluded is £0.600m. These new costs are mainly incurred with the implementation of a new Customer Relationship Management (CRM) system costing £1.3m and planned to be implemented in January 2015 (original planned date was October 2014).

   The billing system new cost justification paper[5] and associated evidence details the selection process undertaken for the new system and progress to date. The main reasons for changing the system were:

   a) To continually improve service to customers and offer a wider range of technically innovative service offerings. For example, our current system could not provide online solutions for customers or be quickly updated or changed to meet new customer demands. Often simple changes would take three to nine months due to developer availability and the relative inflexibility of the system.

   b) Product resilience – the age and small number of customers on our existing system meant very little attention or investment was being paid to it and the number of developers (two) looking after the system was not adequate. This created a sustainability risk which was emphasised when the lead person fell ill.

[5] Billing system new cost justification paper

c) To provide a system that could help us effectively implement the changes required for opening of the non-household retail market in 2017. The current system would require an expensive upgrade to try to accommodate changes. This was not cost beneficial given the issues listed above.

2) Pension deficit costs

During AMP5, we reduced our pension deficit by significantly more than the funding received at PR09. This has been ignored by Ofwat as part of their treatment of pension deficit repair costs in AMP6.

We have already taken prudent steps to control this cost by closing the defined benefit scheme to future accrual in April 2013. However, Ofwat has added an arbitrary efficiency to the funding of a historical pension deficit liability. While not a P&L item, to effectively cap pension deficit funding within the retail control as part of limiting new costs is not appropriate and unreasonable.

While the value is low (£0.007m per annum), it is significant to an efficiently staffed operation that could use the revenue to employ a part-time person to manage peak calls.

In summary, the costs outlined above are real and unavoidable costs (i.e. they will be incurred whether Ofwat allows them or not). As part of Ofwat's materiality threshold calculations, they effectively translate to an additional £0.120m of imposed efficiencies over what is already a very challenging operating expenditure allowance.

We argue that all costs capped under Ofwat's materiality threshold should be allowed in full as part of the opex baseline.

Effect on the household retail control

If we assume that we can manage our IPP costs in line with Economic Insight's recommendations of a 1.29% per annum increase in base costs, then without a shift in Ofwat's position, our retail business will be unfinanceable as a standalone entity.

This table shows our regulatory P&L with no shift in Ofwat's position

£ nominal	2015/16	2016/17	2017/18	2018/19	2019/20
Revenue	**4.471**	**4.595**	**4.699**	**4.790**	**4.815**
Base opex	4.111	4.141	4.171	4.201	4.231
IPP incurred at 1.29% per annum	0.109	0.164	0.220	0.277	0.334
New costs allowed In full	0.083	0.121	0.159	0.192	0.222
EBITDA	**0.168**	**0.169**	**0.149**	**0.120**	**0.028**
Depreciation	0.054	0.110	0.173	0.236	0.233
Interest	-	-	-	-	-
Tax	-	-	-	-	-
Net profit	**0.114**	**0.059**	**- 0.024**	**- 0.116**	**- 0.205**

Please note that this already assumes we can manage our IPP in line with Economic Insight's much more challenging IPP profile when compared to our June 2014 submission. The losses by 2019/20 equate to approximately eight full-time staff to achieve a break-even position out of a base of 65 staff (12% of the workforce), in addition to the efficiencies required to meet the new IPP position. If we are unable to make the efficiencies outlined in Economic Insight's report, our losses would equate to 24.5 staff (37% of the workforce).

Representation

For the standalone retail business to make a reasonable return and continue to deliver excellent service, we require Ofwat to make the following adjustments to the company's cost to serve:

Adjustments required to the company's cost to serve

£ nominal	*2013/14*	2015/16	2016/17	2017/18	2018/19	2019/20
Base opex as agreed with Ofwat	*4.184*	4.111	4.141	4.171	4.201	4.231
Revised IPP		0.109	0.164	0.220	0.277	0.334
New costs allowed in full		0.083	0.121	0.159	0.192	0.222
Materiality adjustment		-	-	-	-	-
New opex allowed		**4.303**	**4.426**	**4.550**	**4.670**	**4.787**
Plus depreciation		0.054	0.110	0.173	0.236	0.233
New cost to serve		**4.357**	**4.536**	**4.723**	**4.906**	**5.020**
Additional opex required		0.148	0.202	0.258	0.315	0.372
Additional revenue required		0.149	0.204	0.261	0.318	0.376

The table below shows that a relatively modest increase to the allowed cost to serve will make an immaterial difference to the overall household retail returns, but will provide us with a revenue stream that will allow our household retail business to be financially viable.

Our revised regulatory P&L with allowed IPP and new cost adjustments shows that the household retail business becomes financially viable

£ nominal	*2013/14*	2015/16	2016/17	2017/18	2018/19	2019/20
Revenue		**4.620**	**4.799**	**4.960**	**5.108**	**5.191**
Opex	*4.184*	4.303	4.426	4.550	4.670	4.787
EBITDA		**0.317**	**0.373**	**0.410**	**0.438**	**0.404**
Depreciation		0.054	0.110	0.173	0.236	0.233
Interest		-	-	-	-	-
Tax		0.053	0.053	0.047	0.040	0.034
Net profit		**0.211**	**0.210**	**0.189**	**0.162**	**0.137**

We urge Ofwat to recognise that the household retail control as it currently stands will result in the household retail business not being financeable as a standalone business.

We request that our overall cost to serve is increased in line with the calculations above which have been adjusted following the independent assessment by Economic Insight and which allow for our new costs in full.

5. Representation 3

The PAYG ratio

Introduction

Key points

- We have conducted statistically robust research on customers' preferences for smoothed bills.
- A significant majority support a bill profile smoothed over 10 years.
- Ofwat's draft determination intervention to reduce our PAYG ratio from 80% to 75% on the basis that we did not have customer support introduces instability to a previously modelled stable bill profile.
- We request that Ofwat reconsider their response to the company's approach to delivering a price cut followed by broadly smoothed bills over the next 10 years using a PAYG ratio of an average of 78.75% over AMP6.

Background

Customers have consistently told us that they value smooth bill profiles, and the PAYG ratio we proposed in our June submission received strong support from the CEPF. This is confirmed in the minutes of the CEPF meeting on 18 September 2014. The CEPF continue to support our proposals, describing the bill impact in 2020 of a 75% ratio as 'quite frightening'[6].

We acknowledge that in setting the PAYG ratio at 75%, Ofwat has attempted to reflect our proposed bill profiles over AMP6. However, the draft determination profile does not result in longer-term stability for customers, creating a step increase of around 5.5% in Year 1 of AMP7.

In Table A5.5 of the company-specific appendix Ofwat states:

'Sem[b]corp Bournemouth Water should engage and obtain explicit customer support if it subsequently proposes to change PAYG levers in response to the draft determinations.'

We accept that we did not ask this question specifically of customers during acceptability testing; therefore in response to Ofwat's challenge we have conducted quantitative research with customers.

[6] CEPF minutes 18-09-2014 v3 – FINAL page 7/8

Customer research

225 households and 100 non-household customers were interviewed on their preference for bill profiles over 10 years.

Customers were provided with the context behind the question to be asked[7] and presented with showcards illustrating the bill profiles to 2025 resulting from PAYG ratios of 75% and the original 80% proposed by us.[8]

They were then asked for their preference via a simple 'either/or' question.[9]

Respondents expressed a significant preference for smoothed bills, with 69% of households and 66% of non-households preferring option 1[10].

More information is presented in Chapter 13, 'Customer engagement following the draft determination.'

Remodelled PAYG ratio

We have therefore remodelled our PAYG ratio to reflect a stable bill profile across 10 years.

The tables below illustrate revenues, RCV and Ks for Ofwat's PAYG ratio of 75% and our proposed revised 78.75% (average) over AMP6.

Our proposed revision:

- reflects the draft determination data as delivered on 29 August 2014
- delivers customers' preference for smoothed bills over 10 years.

Ofwat PAYG Ratio	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
PAYG ratio	72.10%	73.70%	74.90%	76.20%	77.70%	75.00%	75.00%	75.00%	75.00%	75.00%
Allowed revenues	32.481	32.430	32.093	31.358	31.081	32.761	32.761	32.761	32.761	32.761
Allowed charges from customers	31.585	31.534	31.197	30.462	30.185	31.771	31.820	31.867	31.912	31.956
Wholesale K	0.0%	-0.2%	-1.0%	-2.3%	-0.9%	5.4%	0.0%	0.0%	0.0%	0.0%
Average RCV	142.120	143.794	144.808	145.178	144.931	144.987	145.607	146.201	146.772	147.321

[7] Customer research – water concepts
[8] Customer research – research showcards
[9] Customer research – HH and NHH customer questionnaires
[10] Customer research final report Nuance

Note: No 'K' is quoted for 2015/16 because of the different approach being taken to setting revenues for PR14.

Revised PAYG Ratio	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
PAYG Ratio	74.20%	75.60%	77.72%	81.80%	84.44%	75.00%	75.00%	75.00%	75.00%	75.00%
Allowed revenues	33.048	32.884	32.726	32.568	32.410	32.436	32.436	32.436	32.436	32.436
Allowed charges from customers	32.152	31.988	31.830	31.672	31.514	31.419	31.482	31.543	31.601	31.657
Wholesale K	0.0%	-0.5%	-0.5%	-0.5%	-0.5%	0.1%	0.0%	0.0%	0.0%	0.0%
Closing RCV	141.830	142.974	143.401	142.776	141.141	140.550	141.347	142.112	142.847	143.552

Variance	15/16	1617	17/18	18/19	19/20	20/21	21/22	22/23	23/24	24/25
Additional revenue	0.567	0.454	0.633	1.210	1.329	-0.325	-0.325	-0.325	-0.325	-0.325
Difference in RCV	-0.289	-0.821	-1.407	-2.402	-3.790	-4.437	-4.260	-4.089	-3.926	-3.769
Average new PAYG ratio	78.75%									
Average Ofwat PAYG	74.92%									

We acknowledge that the above figures, being based on the draft determination, may change if the final determination differs from the draft.

Representation

Customer research has confirmed that a 75% PAYG ratio introduces bill instability that the majority of customers do not want.

We argue that to deliver a smoothed bill profile over the next 10 years our PAYG should be 78.75% over AMP6.

6 Representation 4

Wholesale – NEP invasive species

Introduction

Key points

- We propose in our plan as part of the National Environment Programme (NEP), investigative work to control invasive species which have been agreed with the Environment Agency (EA).
- The NEP will become a statutory obligation.
- The EA has confirmed that this is the first time that investigative work in to the control of invasive species has been included in the NEP. In addition, it has only been included for four companies in the South West. Therefore the costs cannot have been included in the industry's historic cost base, and so would not have been allowed for in Ofwat's econometric modelling.
- The submitted cost of £0.195m satisfies Ofwat's four tests as laid out in the risk-based review.

The need for recognition of investigative work in relation to invasive plants and fish

It is considered by Defra and environmental agencies[11] that 'without understanding of the distribution of non-native invasive species on water company assets, pathways of spread via activities such as water transfer 'the ability to undertake the obligations listed below [12] will be hindered at the least and impossible at worst'.[13]

Increasing legislation and understanding of impacts of non-native species on the economy and biodiversity mean that investigations will allow prioritisation of actions needed for eradication/control to meet statement of obligations and other legislation. In the EA's view this will ultimately save money for the water companies and their customers while meeting the above requirements.

A statutory requirement to undertake work in relation to invasive plants and species has been included in the company's NEP assessment.

This work is new to the industry and has been introduced for the first time by the EA and only for four water companies in the South West region as part of the NEP. The EA has also confirmed that this is the first time that investigation work has been included in water company plans.

[11] http://www.nonnativespecies.org/home/index.cfm
[12] Defra Statement of Obligations sections 3.12: England Biodiversity Strategy and 3.13: The Habitats and Wild Birds Directive
[13] Quote from Environment Agency Biodiversity specialist via SBW CCG member - 26.9.2014

Our June submission contained details of our proposals to investigate certain invasive species of plants and fish, especially where they impact on sites of environmental importance. We intend to survey all of the company's sites, record and report on invasive species, and work with the E A and Natural England over the longer term to minimise or where practicable, eradicate such species for high-priority sites.

An allowance of £0.195m for invasive species work is included in our business plan submission. This was part of the £0.795m rejected during Ofwat's 'deep dive assessment' under the heading 'catchment management expenditure'. See Table AA1.4 of the company-specific document.

We address the reasons for the failure of the deep dive assessment for catchment management work in Chapter 6 'Wholesale – NEP catchment management'.

However we believe that the atypical and new cost for invasive species has been overlooked and has therefore been inadvertently rejected without consideration.

Satisfying Ofwat's four cost assessment tests

We have engaged an independent expert third party to review our proposal and their analysis is provided.[14]

In summary they conclude that the proposed costs are comparatively very low when considered against known costs for similar work.

Is there compelling evidence of need for the programme?	Yes. The need for the work is driven by a statutory requirement.
Is it justified by cost benefit analysis and strategic optioneering?	Yes. Our proposal has been independently reviewed by an expert third party organisation which has confirmed the potential costs for delivering the required output. They confirm that the costs proposed of £0.195m (or equivalent £0.039m pa) are low when considered from two options, either for the recruitment of an internal resource or the use of external specialist consultants.
Is there robust evidence on costs?	Yes. Sufficient evidence to determine whether the costs represent upper quartile efficiency is unavailable at this point and a benchmarking exercise to gather more detailed information

[14] Cascade Consulting Draft Determination FINAL report

	to provide a valid assessment would be required. However the independent expert organisation has produced itemised estimated costs for the work. These have been compared with our proposed £0.195m. The comparison indicates that in their opinion the proposed cost is likely to be comparatively low.
Will it protect customer's longer-term needs?	Yes. The work will ensure that we comply with our statutory obligations and work in the interest of the environment. The work will protect the longer-term needs of both customers and the environment as without proactive management, invasive species may cause significant damage to the company's assets, the environment and ultimately result in financial liabilities that could impact customers. This general strategy of prevention rather than cure has again been confirmed in recent exchanges with the EA.

Representation

We believe that the atypical and new cost for invasive species has been overlooked and has therefore been inadvertently rejected without consideration.

We argue that:

- Investigative work for invasive plants and fish is a new cost to the industry that cannot be included in Ofwat's historic cost assessment models and therefore needs to be treated as a separate item
- The submitted cost of £0.195m satisfies the four tests laid down in the risk-based review.
- Whilst we acknowledge that this is not a large cost, it is material to the company, especially when taken in combination with other smaller costs considered immaterial by Ofwat.
- Ofwat will be in breach of its own obligations under Defra's Statement of Obligations[15] if it fails to fund this statutory obligation.

[15] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69603/pb13829-statement-obligations.pdf

7 Representation 5

Wholesale – NEP catchment management

Introduction

Key points

- We included two relatively small catchment management schemes in our plan, one of which was supported by the DWI as contributing to the resolution of a known problem of poor raw water quality at one of our sources.
- These schemes are now part of the NEP.
- These schemes must be funded and we provide further evidence in respect of the robustness of the cost estimates and selection of options.

Catchment management – the proposal

Our June submission contained £0.795m of new costs to respond to NEP requirements, of which £0.600m related to catchment management schemes.

Table AA1.4 of the company-specific document confirms that all NEP funding was rejected, having failed to meet the criteria of 'need' and 'robustness of costs'.

This section addresses the catchment management specific failures in Ofwat's deep dive cost assessment.

Deep dive assessment

Regarding the two areas that failed, Ofwat concluded:

	Extract from draft determination
Need	We consider that the company has set out a coherent case for why the investment is needed. SBW states that the expenditure is atypical because it has not done or needed to do this type of work in the past. Investment is driven by deterioration in source water quality which has led to the programme's inclusion in the statutory NEP. For the Lower River Stour, SBW has provided evidence that it is monitoring Metaldehyde levels and has already breached regulatory levels. For the Woodgreen boreholes, SBW provided information showing deterioration in the source water quality and

	has at times been unable to operate within the mandatory 1 NTU turbidity level at water treatment works outlet. Letters of support are provided from both the EA and NE. However, SBW has not provided information to confirm why this type of expenditure is atypical from an industry perspective and therefore will not be allowed for by the industry cost models in the basic cost threshold. Therefore, we do not consider that SBW has provided sufficient evidence to demonstrate Need for this claim.
Robustness of estimate	SBW has provided limited information about the robustness of the costs. For the Lower Stour Valley, the investment (to employ a CSF officer) is stated to be £0.05m per year. This is not discussed further. For Woodgreen, the cost is split out into various components with unit rates presented (consultant hourly rate, cost for sampling Crypto geno-typing etc). No supporting documentation is presented that would give us confidence that the costs are robust or upper quartile efficient.

To address these evidence needs we engaged an independent expert third party to review our proposal in the context of the areas that failed and their analysis is provided.[16]

They conclude and provide evidence that:

- The schemes involve innovative approaches and the use of new analytical techniques and are atypical compared with previous AMP5 catchment management schemes implemented by other water companies. The schemes present challenges of trans-water company boundary catchment management, multi-parameter and multi-source water quality investigations.

- Costs are robust, efficient and within expected bounds for scheme activities of this type.

- The agreement reached with Natural England[17] to fund a Catchment Sensitive Farming Officer is a cost-effective way forward that protects and limits expenditure. In comparison, costs for elements of the water quality investigation for some activities are considered to be marginal under-estimates.

[16] Cascade Consulting Draft Determination FINAL report
[17] Natural England letter – relative CSF significance of the Dorset Stour

Representation

The two tests of whether the proposal is cost beneficial and meets customers' longer-term needs have been passed.

We argue that the evidence provided confirms that our £0.600m proposal for catchment management work in AMP6 satisfies all four test criteria for deep dive cost assessment and should therefore be funded.

We further argue that Ofwat is in breach of its own obligations under Defra's Statement of Obligations[18] if it fails to fund this statutory obligation.

Is there compelling evidence of need for the programme?	Yes. The need for the work is driven by a statutory requirement. The work is also atypical in that it is unlike other catchment management schemes undertaken in the past due to the complexity of the work.
Is there robust evidence on costs?	Yes. Sufficient evidence to determine whether the costs represent upper quartile efficiency is unavailable at this point and a benchmarking exercise to gather more detailed information to provide a valid assessment would be required. However, a bottom-up cost assessment for each catchment management scheme has been reviewed by the independent expert organisation. This indicates that in their opinion the proposed cost is likely to be comparatively low.

[18] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69603/pb13829-statement-obligations.pdf

8 Representation 6

Wholesale – reducing leakage

Introduction

Key points

- Customers rank reduction in leakage as a top priority.
- Customers are willing to pay £1.60 per annum to see leakage reduced to 20 Ml/d by 2020.
- The portion of the costs associated with achieving a leakage reduction beyond today's level has not been allowed due to the mechanistic approach taken in determining revenue.

  We propose to remove £0.313m from our submitted costs to reflect the implicit modelling allowance
- It is important that the remaining £0.627m of costs are allowed, especially as customers are willing to meet them.

Leakage reduction – the proposal

94%[19] of customers have told us that reducing leakage is a top priority. They have also told us they are willing to pay £1.60 more per customer per year to reduce leakage further beyond its current low level.

We operate at the frontier of the industry on leakage but in response to customers' wishes and in line with the PR14 approach of taking on board customer views, preferences and willingness to pay, we plan to achieve further leakage reductions.

We plan to reduce leakage levels from our current level of 21 Ml/d to 20 Ml/d over the next five years. This 5% reduction is made from an already low starting position and we will strive to reduce the levels even further than any formal commitment because it is important to a range of stakeholders.

To achieve this we proposed additional costs of £0.940m and provided the cost breakdown in our June submission.[20]

In the draft determination, Ofwat has rejected the whole of this amount on the basis that £0.313m is already allowed in totex through the cost assessment methodology, and the balance of £0.627m being 0.46% of totex is not allowed because it is below a materiality threshold of 0.5% of modelled totex (by 0.04% or £60,000).

[19] Quantitative research – slide 25
[20] Wholesale cost assessment – new costs NEP leakage, pages 8-22

£0.627m is a material figure for the company and represents almost two-thirds of the cost we expect to incur. We acknowledge that the cost is a forecast and that we might outperform in terms of achieving the desired outcome at a lower cost. If we achieve this at a lower cost, the menu will address this as part of the overall cost reconciliation.

This exclusion means we will find it far more difficult to deliver what customers have clearly said they want and are willing to pay for. The decision goes against customers' express wishes.

From a customer's perspective this appears to be a very harsh outcome given that the reason for excluding 67% of the expenditure is due to the assessment methodology rather than to any economic or technical argument. Therefore we contend that at least the amount of £0.627m should be allowed as the additional amount that is atypical in nature and cost-beneficial to customers.

The arguments to support this are below.

Cost benefit in favour of customers

The willingness to pay £1.60 per customer per year for a 5% leakage reduction equates to an overall figure for willingness to pay of £1.6m over five years. This compares favourably with the cost for the leakage reduction work of £0.940m. There is therefore a significant overall cost benefit of £0.684m to customers from doing the work, which is why we included this in the plan.

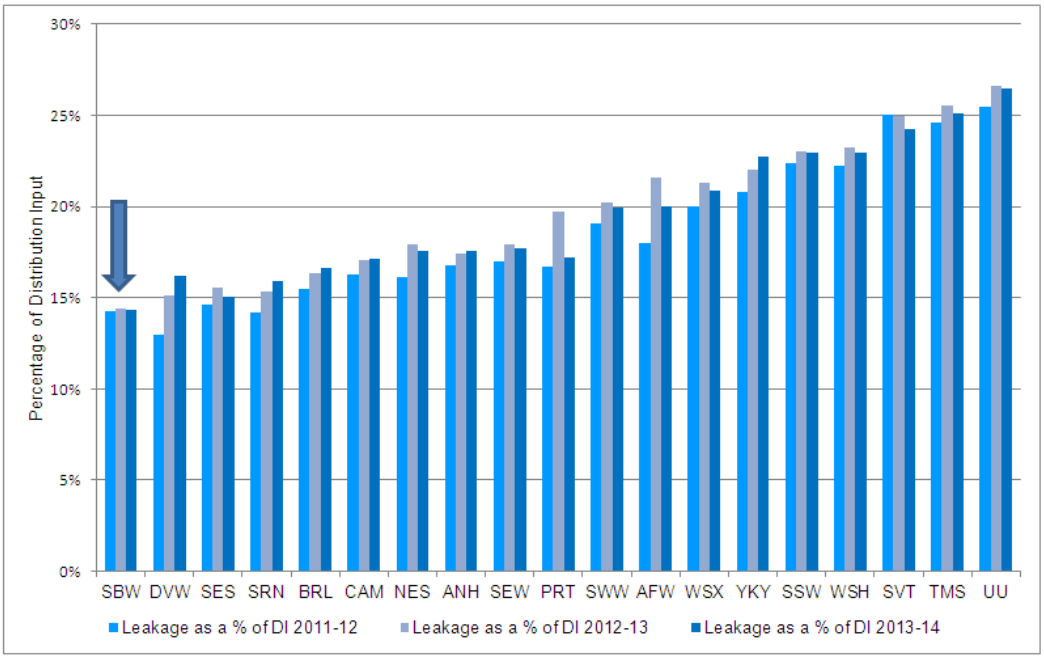
What the £0.940m includes

The £0.940m includes a combination of leakage detection and pressure optimisation costs of £0.640m and repair costs of £0.300m. These costs have been robustly calculated.

All of this activity is in response to customers' wishes, is completely new and represents activity over and above that included in our current cost base. However, we accept that the modelling may include an allowance for leakage reduction because many companies, including ourselves have been generally reducing leakage over time.

Current position at the frontier of leakage efficiency

Our current leakage level is at the frontier of performance of the industry as a whole.



Most of the amount we proposed to reach the new target is over and above anything already allowed in our opex – what is allowed already is only to maintain the current position.

Although Ofwat's cost models based on industry average figures will have some allowance already included for leakage, few companies in the industry are at the same performance level as us and we are therefore breaking new ground in reducing levels even further.

ODIs

We have committed to sharing the benefits of outperformance in leakage reduction with customers, whether this be by beating the leakage commitment, or by achieving our objectives at lower cost.

Therefore, there are additional benefits to customers for the achievement of ODIs. These benefits will again outweigh the costs. Exclusion of the expenditure designed to achieve further leakage reduction will put the company in a difficult position with respect to committing to the ODI and the associated range of RORE outcomes.

Assessment methodology

£0.627m has been excluded by Ofwat because the amount is below the defined materiality threshold, albeit by a fraction. This is a mechanistic process and takes little account of company-specific circumstances. For this company, in such an important area of activity, this amount cannot be considered as immaterial.

Satisfying Ofwat's risk-based review criteria

Is there compelling evidence of need for the programme?	Yes. Over 94% of customers have told us they want us to reduce leakage and 75% are willing to pay the costs of achieving this. The work is atypical in that it is • pushing the upper quartile performance frontier significantly • funded by customers' willingness to pay
Is it justified by cost benefit analysis and strategic optioneering?	Yes. Our proposal was independently verified in June as cost beneficial. [21] As demonstrated in our June submission, the only viable option to reduce leakage is to find and repair leaks and ensure optimum pressure management. We have challenged ourselves to use the most efficient means to do this. We know that most of the additional leak repairs will not arise from visible leaks and will require increased find and fix activity. As an alternative option, replacing infrastructure would clearly have an impact on leakage if carried out at a sufficient level. However, it is widely accepted that in the short to medium term, finding and fixing leaks, together with ensuring optimum pressure management is the most cost beneficial way of reducing leakage.

[21] Halcrow Management Sciences Ltd review of CBA

Is there robust evidence on costs?	Costs are based on verifiable data on leakage detection and repair work and have been independently verified.
Will it protect customer's longer-term needs?	Yes. Reducing leakage will leave more water in the environment and reduce our carbon footprint, as well as ensure improved resilience against extreme dry weather in the future. This supports our Reliable Water Supply and Environmentally Sustainable Operations outcomes. Customers and the environment will be protected from any failure to deliver through outcomes delivery penalties.

Representation

We contend that failure to fund at least a further £0.627m for the atypical reduction in leakage is directly against customers' express wishes. We argue that this is in direct conflict with the stated intention of the PR14 process which offered customers the opportunity for direct engagement with their water company and to 'influence and inform' decisions.[22]

Our proposal is atypical and does not represent 'business as usual', which is what the cost assessment methodology aims to replicate. Leakage will be managed effectively and efficiently as part of our business as usual, and this is effectively what the £0.3131m represents. However, we are at the frontier of the industry and the requirement for a total of £0.940m is to achieve the stretch target for leakage reduction which 94% of our customers support. This is over and above our business as usual leakage management.

If we push beyond the 20Ml/d target, customers will share in any gains that we make. In addition, other customers outside our area of supply will also benefit, as we will push the frontier for other water companies to follow.

The penalties included in the ODI will provide protection for customers. The environment will benefit too by having more water and through reduced carbon emissions.

The representations in this section provide compelling reasons why the proposal should be funded.

[22] http://ofwat.gov.uk/pricereview/pr14/customer/

9 Representation 7

Outcomes and ODIs

Introduction

Key points

- We propose changes to a number of ODIs and PCs as a result of the draft determination. This results in a net change of £1.388m to the maximum penalty level.
- We raise concerns about standardising certain ODIs across the industry as this has resulted in additional financial risk to small companies and some double-counting of penalties.

In this section we propose a number of amended ODIs and targets to replace those set out in the draft determination.

All proposals are set out in our amended data dictionary[23] and the calculations and rationale for amended penalties are set out in the 'representations on PCs' spreadsheet.[24]

Below we discuss our key concerns but for ease of reference, we propose changes to the following PCs. All changes have been independently reviewed for reasonableness – please see section 'reasonableness of proposals to amend ODIs and PCs' below.

Table confirming performance commitments about which we make representation

Reference	Performance commitment	Change and/or concern
A1	Water quality contacts from customers re appearance	Amend dead band to 1.25 from 2017/2020
A2	Maintain compliance with all water quality regulations	Concern: see comments below
B1	Leakage	Request doubled penalty is reverted to original maximum potential penalty See comments below

[23] Data Dictionary – Draft Determination Representation v2 FINAL (clean and tracked versions)
[24] Representations on PCs.xls

B3	Interruptions ≥3 hours	Amended the calculation methodology Retain draft determination penalty See comments below
B4	Serviceability	Concern: see comments below
B5	Metering	Change target to reflect draft determination Retain draft determination penalty for meters not installed See comments below
B6	Per capita consumption	Target changed – see comments below
A1 (retail)	SIM	Target amended to upper quartile See comments below

Performance commitments B5 and B6 - metering and per capita consumption

Our selective metering programme commenced in 2000 and as a result we have installed around 71,000 meters and increased overall household metering penetration to 67%.

Since 2000, average annual distribution input has fallen by around 13% while household numbers have increased by 10% and we attribute this in no small part to metering, which has contributed to customers' increased awareness of the water they use.

Customers also support being charged on the basis of the volume they use and we therefore proposed the continuation of our programme of metering on change of occupier in to AMP6. Our proposed ODIs for metering and per capita consumption reflected our proposals.

The draft determination does not assume a continuation of metering on change of occupier and while we accept this, it will necessitate a revision to two performance commitments and hence outcome delivery incentives.

We propose that both are amended to reflect the 9,300[25] optional meters which we will now install in AMP6. Our proposal uses the same methodology as previously proposed but adjusts the target levels to the number of meters that will now be installed.

[25] As submitted by us in our June submission and accepted in Ofwat's bottom-up totex model

Performance commitment B3 - supply interruptions ≥3 hours

Our performance is industry-leading.

Since the introduction of KPI reporting in 2011/12 we have been placed as follows:

	SBW rank in industry	SBW reported KPI performance (customer minutes)	Average industry KPI (minutes)	Average performance for top 4 companies (minutes)
2011/12	2nd	2.3	20.4	5.1
2012/13	2nd	4.3	19.1	5.9
2013/14	1st	2.0	16.1	6.5

Over time we have consistently been an industry leader in managing interruptions although we always strive to improve. Having a reliable water supply is one of our customers' top priorities and so it is right that we push ourselves hard to minimise interruptions.

The target levels we submitted in June were therefore aspirational and very challenging, particularly when considered against our performance levels. For this reason, we did not propose to attach a financial penalty to our performance commitment. We felt that the reputational penalty of publicising any failure to achieve the target was sufficient for us to strive for it.

While we do not disagree with the application of the ODI penalty, it is disproportionate to the extent of the challenge and our current performance.

Ofwat acknowledges that our performance is 'upper quartile by quite a long way'.[26] We therefore propose the following revised target levels that will:

- continue to challenge us to improve
- ensure that provided that we continue to perform well, we remain comfortably within the upper quartile of the industry.
- impose a penalty that is meaningful but recognises our industry-leading performance.

Performance commitment B1 - reduce leakage

Here we propose clarifications on the associated reward and penalty.

Reward

We proposed in our June 2014 submission that our maximum reward, calculated under the Ofwat methodology, for achieving a stretch target of 17 Ml/d would be £1.167m.

[26] Nathan Warren, Ofwat. SBW/Ofwat call 9 September 2014

This would be applied as £0.0389m for every 0.1 Ml/d achieved over the 20Ml/d target (i.e. 3 * 10 * 0.0389 = 1.167).

We repeat this proposal here as the performance commitment information in the draft determination regarding the committed performance levels table is not clear.

We have updated our data dictionary to reflect this clarification.[27]

Penalty

We proposed in our June 2014 submission our maximum penalty, calculated under the Ofwat methodology, for failing to meet 20 Ml/d and achieving a performance level of only 21 Ml/d would be £1.154m.

This would be applied as £0.1154m for every 0.1 Ml/d not achieved (i.e. 1 * 10 * 0.1154 = 1.154).

However, Ofwat has changed the penalty collar from 21 Ml/d to 22 Ml/d therefore potentially doubling the penalty to £2.308m (i.e. 2 * 10 * 0.1154 = 2.308)

We contest this and believe the penalty should remain at a potential maximum of £1.154m. This would mean that for a collar of 22 Ml/d, the penalty per 0.1 Ml/d not achieved should be £0.0577m (i.e. 2 *10 * 0.0577 = 1.154).

We have updated our data dictionary to reflect this.

Performance commitment A2 - maintain compliance with all water quality regulations: the risk to small companies of using mean zonal compliance as an indicator

In our June 2014 submission we proposed that actual water quality performance should be based on all water quality samples taken under the requirements of the Water Supply (Water Quality) Regulations. This included all samples taken from water treatment works, service reservoirs and from customer taps. The performance was a straightforward percentage of number of failures against total number of samples taken.

The number considered as an appropriate target was 99.95% based on the historical performance given in the table below:

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Trend
Overall % Compliance	99.93	99.92	99.94	99.97	99.97	99.94	99.98	99.95	99.96	99.97	99.99	

For the draft determination, Ofwat has retained the suggested target, but changed the definition to Mean Zonal Compliance (MZC).

[27] Data Dictionary – Draft Determination Representation v2 FINAL (clean and tracked versions)

It has been well-documented by the Drinking Water Inspectorate that the smaller the company, the less statistically robust MZC results will be and that an element of 'chance' over whether a failure will be in a small zone is introduced.

In Scotland, the same methodology for calculating MZC is used, and the Scottish Drinking Water Regulator noted in the latest drinking water quality report:

Zones with small populations

"Some of the water supply zones in Scotland are very small, serving populations in single figures. Regulatory sample frequencies are based on population, hence sampling for certain parameters in these zones is infrequent, with perhaps only two samples being taken for each parameter per year. If one of these samples fails, this will adversely affect mean zonal compliance to a much greater extent than a sample failure in a large supply zone."

To show the effect of zone size (i.e. the numbers of samples taken within that zone), a single failure in a large zone would only contribute a **0.13%** effect on non-compliance whereas a single failure in small zone would contribute **1.25%** non-compliance. This represents a nearly 10-fold difference in effect on the MZC final figure.

To further illustrate this point, in 2013, we had three water quality compliance failures across the network where 12,798 laboratory analyses had been undertaken over the year. This led to a 99.97% MZC result rather than the 99.9998% result you would get by calculating a simple arithmetic percentage of failures to total sample numbers. This is due to the calculation methodology defined by the DWI where the percentage failure is first calculated on a zone by zone basis, with the final overall figure being an arithmetic average of the percentages from all zones.

Over the same period as shown above, the MZC figures are given below:

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Trend
MZC	99.87	99.91	99.87	99.99	99.98	99.91	99.99	99.94	99.98	99.99	99.96	

These figures show a considerable variation due to the statistical effect of being a small water company with a number of small water supply zones, and the way the MZC is calculated.

Therefore, we will carry a very significant risk of failing the target ODI set by Ofwat.

There is a real risk that we will be unreasonably and disproportionally penalised when compared with larger water companies for what could be just one failure.

There are three possible options:

1. Retain our original definition of percentage compliance with regulatory samples

2. Increase the width of the dead band on the ODI to fairly reflect the disproportional statistical effect on a smaller water company (99.91)

3. Use a two or three-year rolling average so as to smooth out the impact of one-off deviations from a trend.

We understand Ofwat's desire for an industry-wide performance commitment. We therefore propose the adoption of either the second or third option.

Performance commitment A1 (retail) - SIM performance

To avoid misinterpretation, we wish to clarify our commitment to performance under the Service Incentive Mechanism, to remain in a position where our score is at least one standard deviation above the industry mean score when ODI outcomes are assessed at PR19.

We will retain a target score of 89 or greater, but not use this specific score to assess any reward or penalty.

Performance commitments A1, A2 and B4 - double-counting water quality performance penalties

Customers rightly take a safe wholesome water supply for granted. Ensuring the water we supply is safe and complies with drinking water standards is a statutory obligation and we agree that all companies should be held accountable for the quality of water they provide.

While we do not disagree with Ofwat imposing financial penalties in respect of water quality performance commitments for all companies, we are very concerned that in doing so elements of water quality compliance are now double-counted as they appear in both the serviceability and water quality performance commitments.

As a result all companies will be subjected to a potential 'double jeopardy' of financial penalties in relation to water quality performance.

We urge Ofwat to remove this potential for incurring two penalties for one service element failure.

Reasonableness of proposals to amend ODIs and PCs

We asked Halcrow Management Sciences to review these proposals in the context of our past and current performance and comment whether, in their opinion, our proposals are reasonable.

Their report is provided as part of this representation.[28]

[28] Halcrow Management Sciences ODIs Assurance Report FINAL

Future assurance of performance levels

As part of our June 2014 submission, we included the 'data dictionary' that would be used as a basis for the evaluation of our achievement of our performance commitments.

We are committed to an open and transparent process for the evaluation of our performance, and after the final determination this document will be provided to both the independent auditor of our performance and our Customer View group (see chapter 4).

The data dictionary[29] has been updated to reflect the draft determination and the proposals made here. Any subsequent revisions will be reflected in a final document after the final determination.

Representation

We contend that some of the draft determination interventions have resulted in ODIs that are not appropriate and, or disproportionate. A one size fits all approach to water quality compliance has created additional risk for small companies.

We therefore propose amendments to a number of them.

In the case of the SIM, we propose an amendment to clarify our performance commitment.

Our proposed revisions to these ODIs remove a maximum of £1.388m in penalties as shown below.

Penalties - potential maximum at DD and Representation (whole AMP £m)

	Draft Determination	Representation	Variance	
A1	0.250	0.246	0.004	Customer contacts
A2	1.420	1.420	0.000	Water Quality
B1	2.308	1.154	1.154	Reduce leakage
B2	0.984	0.984	0.000	Large scale interruptions
B3	1.467	1.467	0.000	Interruptions ≥ 3 hrs
B4	2.250	2.250	0.000	Serviceability
B5	0.477	0.247	0.230	Metering
C1	0.008	0.008	0.000	Fixing visible leaks
Total	9.164	7.776	**1.388**	

The remaining PCs have not changed.
There is no change to the rewards.

The calculations behind our proposal are included as part of this representation.[30]

[29] Data Dictionary – Draft Determination Representation v2 FINAL (clean and tracked versions)
[30] Representations on PCs.xls

10 Representation 8

Wholesale – material impact of data inconsistency

Introduction

Key points

- Ofwat has not updated its cost base model to reflect that we will be installing fewer meters. Data is now inconsistent in differing parts of the model.
- This results in a material adverse impact of £0.840m.
- Ofwat should correct its modelling to reflect its intervention and rectify the adverse impact on the company.
- Correcting the cost base model will reduce the £4.6m cost assessment gap to £3.7m, or 2.8%.

In our June 2014 submission we proposed to continue our programme of metering on change of occupier which has been in place since 2000.

The proposal has been rejected on the grounds that we do not have any supply demand balance issues. During AMP6 we have been funded only for optional meters. While we are disappointed, we accept the decision.

However, we are concerned that Ofwat has not reflected this change to our policy in its cost assessment models. This process issue results in significantly different meter numbers driving different parts of the cost base model.

This data inconsistency leads to skewed results which materially impact the modelled basic cost threshold (BCT) and significantly increases the cost assessment gap.

Wholesale cost assessment – cost modelling

Historic data has been used to populate the PR14 cost models using a mixture of trends and averages. Ofwat's modelling using this data therefore forecasts a total of 29,505 new meters in AMP6 (including new properties).

However the actual number of new meters proposed within Ofwat's modelling is 17,640.

It should be noted that these are modelling assumptions. Our performance commitment for new meter options is 9,300 (see Chapter 8). This is the number proposed by us in our June 2014 submission and accepted by Ofwat. Our forecast of new properties for AMP6 is 5,981. This gives a total of 15,281 or 3,056 per annum.

The cost base model has not been adjusted to reflect that the future will be significantly different from the past in that we will no longer meter on change of occupier. Therefore one element of the model (based on historic performance) forecasts a significantly higher number of meters than will actually be installed.

The following table illustrates the data inconsistency in the cost base model. The table clearly shows that the modelled increase in metered households is inconsistent with the maximum number that actually will be achieved.

Ofwat's cost base model	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**AMP6 total**
Ofwat's forecast new meters (using historic data only) Cost base model line: C00268_W003 (incremental movement)	5,901	5,901	5,901	5,901	5,901	29,505
Ofwat's funded new meters (using cost modelling outcome) Cost base model lines: BN1715_W003 + W4008_W003	3,528	3,528	3,528	3,528	3,528	17,640

The higher forecast, based on historic data which is not representative of the future, materially impacts the final cost assessment, to the company's detriment.

Representation

The draft determination basic cost threshold (BCT) increases from £110.612m to £111.452m (post upper quartile efficiency) if the funded increase in metered households of 3,528 per annum is reflected in models rather than the historic number of 5,901.

This is an increase of £0.840m over AMP6 and is material.

We argue that as a result of the draft determination decision not to fund selective metering, there should be a two-sided adjustment that recognises that our future metering activity will not be equivalent to that assumed in the cost assessment models.

Correcting the cost base model will reduce the £4.6m cost assessment gap to £3.7m, or 2.8%.

11 Representation 9

Reductions in proposed cost base

Introduction

Key points

- The cumulative impact of excluded items is material and disproportionate for a small company.
- Data inconsistency in Ofwat's cost assessment modelling has created a further material adverse impact on the company.
- To reflect that our metering programme on change of occupier will no longer be funded we propose to reduce our wholesale baseline costs.
- We also propose to remove £0.313m from our submitted atypical costs for leakage reduction to reflect the implicit modelling allowance.
- We have reduced our household retail input price pressure (IPP) claim following an independent third-party review.
- We request Ofwat to accept the proposed amendments in the context of the material impact these exclusions have on a small company.

Combined impact of Ofwat's non-material exclusions

As we have analysed the draft determination we have become concerned at the extent and impact of items that have been excluded from our plan as being 'non-material' or above a materiality threshold. In addition the application of efficiencies on historic costs is not appropriate.

Ofwat's use of a materiality threshold in the retail household control disproportionally penalises small companies. To illustrate, the impact of the retail cost reductions over AMP6 equates to 24.5 full time staff out of a total headcount of 65. We argue that this is unrealistic.

Cumulatively these items have a significant impact on a small business, as shown in following table.

Cost exclusion	Year 1 impact £m (nominal)
Efficiency on historic pension liabilities	(0.050)
New retail costs above materiality threshold	(0.120)
Reducing leakage	(0.138)
Total impact – year 1 Percentage of year 1 appointed business revenue	(0.308) 0.75%

Symmetrical adjustment to the cost assessment models and baseline totex

Due to a difference of opinion over justification of our proposal, our programme of metering on change of occupier will not continue. We accept this and therefore adjustments should be made to Ofwat's own modelling and our cost base to remove it.

We make representation in Chapter 10 over the changes needed to Ofwat's models and request that Ofwat adjust our baseline totex submission by £1.810m to reflect the removal of the proposal.

Implementing a two-sided adjustment will decrease the cost assessment gap further.

£m	June submission	Remove metering	Representation	Revised totex
SBW wholesale totex	136.429	(1.810)	134.619	136.619
Modelled BCT	110.612	0.840	111.452	132.74
Revised Cost assessment gap				1.879 1.4%

Representation

We have made the proposed wholesale cost adjustments in direct response to Ofwat's cost assessment modelling assumptions.

Following independent third-party review of our retail IPP claim, we submit revisions to our proposed retail cost base.

In view of the material impact of combining Ofwat's 'non-material' cost exclusions, we contend that Ofwat should accept the following adjustments to our June 2014 submission.

	Nature of Adjustment	June Submission £m	Representation £m	Reason for adjustment
Wholesale	Remove selective metering from baseline submission	1.810	0.000	Selective (occupier change) metering not allowed as company does not have a supply demand balance challenge. See Chapter 9.
	Reduce proposed atypical cost for leakage reduction driven by customer need and willingness to pay	0.940	0.627	£0.313m implicit allowance for leakage reduction already included in Ofwat's modelling. See Chapter 7.
Household retail	Reduce IPP claim from 1.9% to 1.29%	2.670	1.104	Proposed IPP claim reduced to reflect independent third party modelling. See Chapter 3.
Non-household retail	No adjustment	N/A	N/A	N/A

12 Ofwat requests for additional information

Introduction

Key points

- We have revised our Customer View proposals following consultation with the Customer Engagement Planning Forum (CEPF).
- Quantitative research has confirmed that customers accept the weighted average cost of capital uplift in their bills.
- There have been no further coliform failures at our water treatment works.
- We provide independent verification of our PR09 output delivery.
- We provide an explanation of movements in our non-household retail costs.
- We have remodelled our expected RORE range which, based on draft determination funding and service obligations with associated proposed amendments to ODIs, does not change materially.

The Customer View group and gainsharing with customers

In section A5.2 of the company-specific appendix for SBW, Ofwat details its concerns regarding our proposed sharing mechanism and asks us to consider further developing the proposal and to address customer protection issues with our CCG.

On 18 September, we presented a paper to the CEPF [31]. The appendix to the paper provided members with the current status of the proposals, as submitted to Ofwat in July 2014.

During the subsequent discussion we agreed the following:

- The mechanism will be gainshare only.
- The mechanism will be structured so that customers are only able to gain from it.
- Audited data on turnover, opex, capex, financing costs, tax and equity returns, plus service performance and delivery of all commitments, will be submitted to the Customer View group so that in addition to challenging us on service delivery performance the group can challenge on whether it believes we are earning excessive returns.
- It is not appropriate to attempt to derive any equation for the mechanism in advance. The CEPF strongly supported this view.

[31] Paper 6 – pain and gainsharing in AMP6

- The data and summaries of the discussions with the Customer View group will be placed in the public domain.

We have updated our July 2014 proposal to reflect these agreed areas.[32]

Additional customer research on cost of debt

We have conducted quantitative research in response to Ofwat's requirement for us to establish whether customers are content to pay the company-specific uplift on the cost of capital through bills, taking account of the benefit the uplift generates.

The outcome is that customers support the small additional cost to them of being served by a company which is a good efficiency comparator in the industry

See Chapter 13 'Customer engagement following the draft determination'.

Water treatment works coliforms performance

In table AA3.12 of the company-specific appendix for SBW, Ofwat requires us to demonstrate our latest performance as part of this representation, and in advance of the final determination.

Performance during 2014/15

The overall percentage of water treatment works total coliform performance demonstrates an improving trend over AMP5. There have been no detections since 2012.

We include a paper as part of this representation that provides further details of the performance and the work at Alderney water treatment works to improve the disinfection process, a significant part of which has been completed.[33]

We will update this paper for Ofwat prior to the final determination. We will liaise with our Portfolio Lead on the required timescale.

Independent assurance of performance

Halcrow Management Sciences have independently verified and assured our data and performance.[34]

[32] Customer View – gainsharing with customers – September 2014 FINAL
[33] Water treatment works coliform performance
[34] Halcrow Management Sciences Coliform Compliance Assurance Report FINAL

Change protocol - AMP5 service standard outputs

Section A3.6.6 of technical appendix A3, and annex 3, page 50, of the company-specific appendix for SBW refer to Ofwat's expectation of companies to report progress against the service standards laid down in the final determination supplementary reports in 2009.

The sections go further to state that *'in many cases…..there is a lack of compelling evidence that service standards have been achieved'* and that *'for the purposes of these draft determinations, we will not be applying shortfalls on this issue conditional upon this information being provided as part of companies' draft determination representations.'*

Our Portfolio Lead has confirmed in discussion that we have already provided the required information to give Ofwat assurance that the required AMP5 outputs will have been delivered, and that in the case of meters, logging-down is appropriate. We presented our forecast AMP5 performance in our June 2014 submission.[35] However, we confirm that:

- We are on course to broadly deliver the required outputs.
- Our June 2014 forecasts remain valid.
- The majority of the indicators have been annually audited, either through the June Return process or subsequently through our internal Annual Return, which replicates the June Return.
- Halcrow Management Sciences have been requested to verify these comments. We provide Halcrow's assurance of the delivery of these outputs as part of this representation.[36]

Non-household costs

Ofwat has asked us to explain the reason why we expect our projected non-household costs to decrease by some 20% between 2013/14 and 2019/20 whereas our projected household costs do not show a similar decrease.

The following table summarises the movements from 2013/14 to 2019/20 between our December 2013 and June 2014 Table R4 submissions.

[35] 11 Adjustments to the 2010-15 price control – pages 10-17
[36] Halcrow Management Sciences AMP5 Service Standard Outputs Assurance

£m	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Line 1 Table R4 December 2013	0.630	0.680	0.680	0.680	0.680	0.680	0.680
Costs reallocated following Ofwat guidance	-0.374	-0.371	-0.371	-0.379	-0.385	-0.390	-0.393
Revised costs in June 2014 submission	0.256	0.309	0.309	0.301	0.295	0.290	0.287
Additional costs incurred in 2013/14, not in December submission	0.108						
Line 1, Table R4 June 2014	**0.364**	**0.309**	**0.309**	**0.301**	**0.295**	**0.290**	**0.287**

The first line of the table shows the data submitted in December 2013. This shows costs increasing by £0.050m in 2014/15 and then being held constant. This is because we had anticipated incurring cost (that was actually incurred earlier than expected in 2013/14) in later years – see below.

The second row of the table shows cost reallocations following publication of the retail cost allocation guidance.

The third row therefore details the amended December 2013 data.

The fourth row shows additional costs incurred in 2013/14, which were above those shown in the December 2013 submission.

The final line shows the amended data submitted in June 2014. Due to the additional costs incurred in 2013/14, the amended data shows a reduction of £0.081m (22%) from £0.364m in 2013/14 to £0.287m by 2019/20.

However, the bulk of this reduction (£0.055m, or 15%) occurs in 2014/15 and results from our 2013/14 total of £0.364m being actual costs, whereas the later years are the forecast costs submitted in December 2013.

By not changing our AMP6 forecasts to reflect the additional 2013/14 costs, our submitted figures suggest a significant percentage reduction in costs. However, the movement of £0.022m from 2014/15 to the end of AMP6 is 7%, which represents cost efficiencies.

It is worth highlighting that our non-household costs are relatively small, and small numbers are large as percentages (ie £0.108m is 30% of 2013/14 non-household costs, but would represent only 2.7% of household costs for the same period.)

Restated RORE

We have recalculated our RORE range to demonstrate the impact of the draft determination and our amended proposals.

This demonstrates that based on draft determination numbers and proposed changes to ODIs, the range does not change materially.

As requested by Ofwat (e-mail of 15.9.2014), we resubmit tables A20 and A20a [37] and the Risk Assessment Tool.[38]

[37] A20 & A20a values 011014
[38] Risk Assessment Tool _SBW (DD and New ODIs)

13 Customer engagement following the draft determination

Introduction

Key points

- We have conducted quantitative research in to the cost of debt uplift for a small company and customers' preferences with regard to bill profiles up to 2025.
- The Customer Engagement Planning Forum (CEPF), our customer challenge group, met to discuss the draft determination and any resulting customer-related issues.
- In line with Ofwat's information note IN 14/14, we consulted the CEPF on our non-household tariff proposals.

Customer Engagement Planning Forum

Meeting 18 September 2014

A full CEPF meeting was held on 18 September 2014.

Full minutes of the meeting are included in this representation,[39] along with the challenges issued by CCWater prior to the meeting, and addressed in the presence of the full CEPF.[40]

Key points agreed at the meeting were:

- The CEPF support our proposals for a gainshare mechanism and the associated openness and transparency in the gainshare process, and agree that a formulaic approach will be difficult to determine in advance.
- Proposals for gainsharing will not include a 'painshare' element, as has been previously considered.
- The CEPF supported the 80% PAYG ratio because of the 'very predictable' bill profile it results in. Members felt the proposal was 'innovative'.
- The Environment Agency and Natural England will work with us on our representation for funding for the National Environment Programme.
- With reference to Information Note IN 14/14 regarding the non-household price control, members are content in principle with our proposed bill levels and structure, agree that a two-year control or opener will allow us to fine-tune bills, and are supportive of either a reopener or shorter control so long as whichever is selected is in customers' best interests.

  See Chapter 14 'Non-household tariff proposals' for more detail.

[39] CEPF minutes – 18.9.2014 v3- FINAL
[40] CCWater Questions on SBW's DD ahead of CEPF meeting

Post-meeting engagement

The full CEPF has not met since 18 September; however, we have continued to engage with individual members to ensure that the actions from the meeting are fulfilled.

These activities include liaison with:

- the deputy Chairman, a non-household customer and deputy Chairman of the Dorset Local Enterprise Partnership, over our non-household tariff proposals,
- the Environment Agency and Natural England regarding the National Environment Programme,
- members regarding minutes of the meeting, and
- all members regarding this representation.

Customer research

We have conducted quantitative research[41] interviewing 225 household and 100 non-household customers regarding two areas:

1. the proposed company-specific uplift on the cost of debt, and
2. bill smoothing using the PAYG ratio.

Company-specific uplift on the weighted average cost of capital

Ofwat has applied a 15bp company-specific uplift to the WACC in recognition of the additional financing costs incurred by us as a small company, and our contribution to the industry and offsetting benefits to customers.

However, section 1.2.4 of the Annex to Technical Appendix 6 requires us to undertake additional customer research to identify whether customers are content to pay the company-specific uplift on the cost of capital through bills, taking account of the benefit the uplift generates. The results of this work are provided later in this section.

Bill smoothing using the PAYG ratio

In the commentary of section 5.4 of the company-specific appendix for SBW, Ofwat comments *'Sem[b]corp Bournemouth Water should engage and obtain explicit customer support if it subsequently proposes to change PAYG levers in response to the draft determinations'.*

Customers have consistently told us that they value smooth bill profiles, and the PAYG ratio we have proposed received strong support from the CEPF. This is confirmed in the minutes

[41] Project plan and confirmation – Nuance Research Ltd

of the CEPF meeting of 18 September 2014. The CEPF continue to support our proposals, describing the bill impact in 2020 of a 75% ratio as 'quite frightening'[42].

We accept however, that the question was not asked specifically of customers during acceptability testing; therefore we have conducted further research.

Research material and CEPF input

The research material was developed in conjunction with the professional researchers we have used throughout the PR14 process, and with the research sub-group of the CEPF.

Methodology

To ensure the robustness of the stimulus material, it was developed in conjunction with the CEPF research sub-group and our professional researchers.

At the start of each section customers were provided with the context behind the questions to be asked.[43] They were then asked a simple 'either/or' question relating to each section.[44] For the question relating to bill smoothing, customers were also presented with showcards illustrating the bill profiles to 2025 resulting from PAYG ratios of 75% and the original 80% we proposed.[45]

Household customers were interviewed in their homes. This approach optimised the time available to conduct the research and enabled researchers to select a demographically representative sample with relative ease.

Non-household customers were interviewed by telephone after random selection from the company's database.

Research results

Our researchers' report states:

- *"Looking at the cost of borrowing issue, there was a significant preference among both household and non-household customers for the 'I accept that part of the higher cost of borrowing to fund improvements is included in customers' bills' option.*

  50% of household customers and 70% of non-household customers chose this option, compared to 40% of the households and 27% of the non-households surveyed choosing the '…should not be included in bills' option.

- *Examining the bill profile options, there was a clear and highly significant preference among both household and non-household customers for 'evened out' bills over bills that reflect the actual price changes each year.*

[42] CEPF minutes 18-09-2014 v3 – FINAL page 7/8
[43] Customer research – water concepts
[44] Customer research – HH and NHH customer questionnaires
[45] Customer research – research showcards

69% of the households and 66% of the non-households surveyed opted for 'smoothed' bills, versus only 22% of households and 32% of non-households preferred bills that reflected actual price changes each year."

We provide the research results as part of this representation.[46]

Conclusion

We conclude that:

- Customers are willing to accept paying an additional amount on their bill to reflect the uplift on the WACC for the higher cost of debt.

  From this we are satisfied that we have fulfilled Ofwat's requirement for us to engage with our customers to identify whether they are content to pay the uplift through bills, taking account of the benefit the uplift generates to them and customers more widely.

- Customers continue to value bill stability above shorter-term gain and have made an informed decision to accept a smaller bill reduction now in exchange for greater bill stability.

  In Chapter 5 'The PAYG ratio' we therefore propose a change to Ofwat's draft determination PAYG ratio to 78.75%, which will deliver bill stability over the next 10 years.

[46] Customer research final report Nuance

14 Non-household tariff proposals

Introduction

Key points

- The Customer Engagement Planning Forum (CEPF) broadly support our non-household tariff proposals
- Members support us requesting a shorter price control period or reopener.
- We propose a two-year price control period.

IN 14/14 and engagement with the CEPF

In line with the requirements in Ofwat's Information Note 14/14[47] on 18 September we consulted[48] our CEPF on the proposed structure of our non-household tariffs and our views on Ofwat's invitation to vary the length of the non-household retail control period or request a reopener.

We explained our rationale to the CEPF for not conducting formal research with non-household customers due to the complexity of the subject and consulting them instead. The members agreed[49] on the understanding that we would consult the Deputy Chair of the CEPF, who is a non-household customer.

During the meeting we presented the proposed tariff structure to members[50] and the modelled incidence impacts of the tariffs as they currently stood[51] (pre-draft determination and with additional small-scale work still in progress to ensure compliance with all requirements).

Full details of the meeting and discussion are provided as part of this representation. At the meeting, the CEPF agreed that in principle:

- Members were content in principle with the proposals but wish to see the requested information before commenting on the representation.
- Members agree that two years for a control period or reopener is appropriate
- Members are supportive of either a shorter control period or reopener so long as whichever is selected is in customers' best interest.

[47] IN 1414 non-household customer engagement
[48] Paper 3 – the non-household price control
[49] CEPF minutes 18-09-2014 v3 - FINAL pages 3 and 8-10
[50] Structure of charges
[51] Incidence impacts of new tariffs

Since the meeting we have undertaken the required actions, including submitting the methodology statements from Dr Scott Reid of ICS Consulting and the assurance statement from Halcrow Management Sciences Ltd that were supplied to Ofwat in our June 2014 submission.

In line with the agreed actions from the meeting, we met the Deputy Chair [52] of the CEPF (a non-household customer) on 1 October 2014. The Deputy Chair 'welcomed' our approach to building future non-household tariffs and 'endorsed' the modelled incidence impacts.

Additionally we have supplied data on likely incidence effects on the charges to certain customers within the various proposed tariff bands.

Response to invitation to vary the length of the non-household control

In view of the analyses of the non-household retail draft determination and our consultation with the CEPF, we propose a non-household control period of two years, ending 31 March 2017.

We propose this on the understanding that there is no regulatory penalty for accepting this invitation from Ofwat, as laid out in IN 14/14.

Non-household tariffs for 2015/16

We have continued to work to refine our non-household tariffs since our June 2014 submission. Therefore the tariffs we present here are different to those submitted.

The work we are conducting is designed to ensure that tariffs comply with our obligations, including our Licence and Competition Law. We are also mindful of incidence impacts on customers and are working iteratively to continue to challenge our own work to ensure that default tariffs are competitively and commercially robust but also take customers' best interests in to consideration.

The underlying methodology provided to Ofwat in our June submission remains unchanged.

While we will continue to work on our tariffs for 2015/16, we do not anticipate those we submit in Ofwat's tariffs template to change significantly. Any amendments will be made as a consequence of our iterative internal assurance process.

Draft charging appendix

We have updated our proposed tariffs to reflect the draft determination and our submitted completed spreadsheet[53] reflects this.

There is still work to do to ensure that the 2015/16 tariffs are robust and recover revenues correctly. In the meantime, we make the following observations:

[52] Philip Warr BSc (Hons) FRICS FRSA FIoD Chief Executive P H Warr plc
[53] Draft charging appendix_FINAL SUBMITTED

- We have had difficulty in reconciling our tariffs to the draft determination figures.
- Please note that we have changed two formulae to correct calculations to £000s rather than £m. We have highlighted this in the spreadsheet.
- We are broadly collecting the wholesale draft determination revenues as shown below:

£m (nominal prices)	Draft determination	Charging appendix
Household	21.783	21.238
Non-household	12.870	13.174
Total	34.653	34.412

- Some of the variance is attributable to our current forecast RPI of 2.49% versus Ofwat's modelled 3.4%.
- Our household retail tariffs are largely recovering draft determination revenues. However, our non-household retail tariffs are currently under recovering.
- The household and non-household unmetered tariffs in particular are not correct, as they currently suggest a significant bill decrease for these customers.
- Until now our tariff development work has focussed on cost allocation and understanding incidence impacts. We are satisfied that the work we have done to date is robust and that the current tariff structure is appropriate and defendable.
- Our tariff modelling to date confirms that most customers will receive a significant bill decrease in April 2015. We do not forecast any customer receiving the threshold nominal bill increase of 5%.
- We will now focus on understanding the variances in the modelling and remodel our tariffs accordingly. This may include rebalancing within the wholesale control if appropriate.

Assurance

Our submitted tariff spreadsheet contains updated tariffs set using draft determination data. However, we are challenging a number of areas and assumptions made and will therefore feed any subsequent adjustments through to our finalised tariffs.

Our submission has been independently reviewed and assured by Halcrow Management Sciences, who will be asked to repeat the work prior to the submission of our finalised 2015/16 tariffs on 16 January 2015. Halcrow's assurance statement has been presented to our Board and is included as evidence as part of this representation[54].

[54] Halcrow Management Sciences Tariff Spreadsheet HMS Assurance Report FINAL