Right deal · Right now ·

Business Plan 2025-2030

Summary of our Draft Determination response

South West Water

Bournemouth Water

Isles of Scilly Water

Bristol Water

Representation Meeting Key Points - 4 September 2024

Overview of Draft Determination (DD) response

- In many ways, the plan we submitted in October was a 'no surprises' ambitious plan, building on what we are already doing and delivering on what matters most to customers and stakeholders today.
- We welcome Ofwat's "outstanding" assessment of our business plan. We developed the plan with a 'straight bat' – we stretched ourselves on cost and service – and we are pleased that the plan was recognised as being high quality and ambitious.
- Our balanced plan focused on tackling the biggest challenges in our region, as we invest in water quality and resilience, continue to fix storm overflows and pollutions and protect the environment from climate change, and tackle affordability for customers. It is in that context, and using that lens, that we reviewed Ofwat's Draft Determination. We are keen to make this work – we are supportive of a number of key aspects:
    a) An updated cost of capital – reflecting market movements from submission
    b) The ability to accelerate c£75m expenditure for storm overflows into 2024/25
    c) The principle of ensuring customers only fund what is delivered
    d) The storm overflow uncertainty mechanism for K8
- We have endeavoured to keep our representations to a minimum, based on having a plan assessed as outstanding – but we have raised areas of representation based on what we believe is fundamental to delivering that plan for our customers.
- The four most significant impacts of the DD which need to be addressed in Ofwat's FD (Final Determination) are:

1. Outcome Delivery Incentives and the balance of risk and return

- From an overarching perspective we have considered whether the Ofwat determined cost of capital matches with the overall risk reward plan position. We agree with the principle of a balanced ODI risk profile, proposing in our plan challenging but realistic outcome targets that will improve environmental and customer outcomes, with an incentive mechanism that drives for improved performance and outcomes.
- Given recent debt issuances (SWW July 2024), the assumed nominal cost of equity of 6.8% is only 50 bps higher than nominal new debt issuance rate. To square the circle of that the negatively skewed ODI incentive regime requires recalibration as it impacts RORE ranges.
- We have considered the DD RORE ranges for K8 which, in our view could result in negative equity and a likely downside risk of 10% (compared to Ofwat's assessed 4%). Our analysis shows that the proposed incentive penalty regime will be five times greater which equates to a £830m financial risk (albeit capped at £500m). The ODI framework drives 7% of this 10% downside risk.
- Through our representation we believe this can be rectified through a combination of incentive rate changes – for example higher positive incentives for bathing waters and internal sewer flooding, that balance the potential downside outperformance without fundamental change to the outcome regime, coupled with a restatement of pollutions targets (which currently would lead to a £230m penalty).

2. Totex allowances and Price Control Deliverables

- Part of our ambitious plan assumed c£600m of totex efficiency (13%) ahead of submission. Ofwat's DD has resulted in a further £525m challenge (Base c£120m, Enhancement c£405m) taking the overall challenge to > £1bn reduction (c25%).

- Having reviewed Ofwat's DD, we appear to be entitled to c£175m additional totex. However, our principle is to seek the totex allowance we originally requested (supported by further evidence) and as such we will not require the additional allowances.

- We also agree that customers deserve to only pay for what is delivered and support the principle of a PCD framework. Indeed, one of the aspects of our original WaterShare mechanism was to 'true up' delivery and specified cost allowances on an annual basis to enable timely sharing with customers of risks and benefits. Through representations we are seeking recognition for an increase in business rates and energy costs as the cashflow risk is significant and certain (noting for business rates the method of calculation is clear as the rates increase formulaically with higher revenues).

- For PCDs it is important that we strike the right balance between scope for deliverability and being held to a delivery schedule which has been recognised in customer bills. Many of our capital interventions will be delivered via programmes, and we need to ensure there is flexibility to support the most efficient delivery. We believe this can work with some simplification including taking a portfolio approach with flexibility to deliver both innovatively and efficiently whilst also removing unnecessary conditions and timing mechanisms.

3. Capital charges recognition and RCV run off

- We believe the RCV runoff should be grounded in the asset lives given the investments made over time that have been recognised in the RCV. We believe affordability arises from us targeting an efficient cost base alongside introducing innovative tariffs and schemes to tackle affordability. We have committed and additional £5m shareholder fund on top of enduring schemes which have delivered £100m of targeted support in K7 alone.

- We note Ofwat's approach of adjusting the RCV run off rates to reduce bills in the short term, however an unintended consequence is that it costs customers more in the long term (c£60m) whilst also deferring essential revenue, hence why reverting with the natural rate is fairer to customers.

- Ofwat's use of revenue levers also impacts available equity headroom as we deliver through the K8 period. We have calculated that c£200m has been eroded and requires restatement to support the cost of equity determined.

4. The regional and priority lens

- Our plan delivers a step change for the communities that we serve – as well as being focused across our customers' four key priorities. There is a proportionally greater challenge to some of our smaller regions, where arguably investments are most needed. For example, Bristol having a c40% challenge and the Isles of Scilly having a c65% challenge. Additionally, in looking at the four priorities, nearly half of the investment reduction has been applied to the areas of bioresources, catchment improvements and river water quality – critical for our success. We are representing to ensure regional and priority improvements are back in balance.

In summary, addressing these four aspects of the DD, will return the plan to balance, avoiding concerns from rating agencies and investors about the financeabilty and investability of the sector and also delivers what customers and stakeholders have asked us to do.