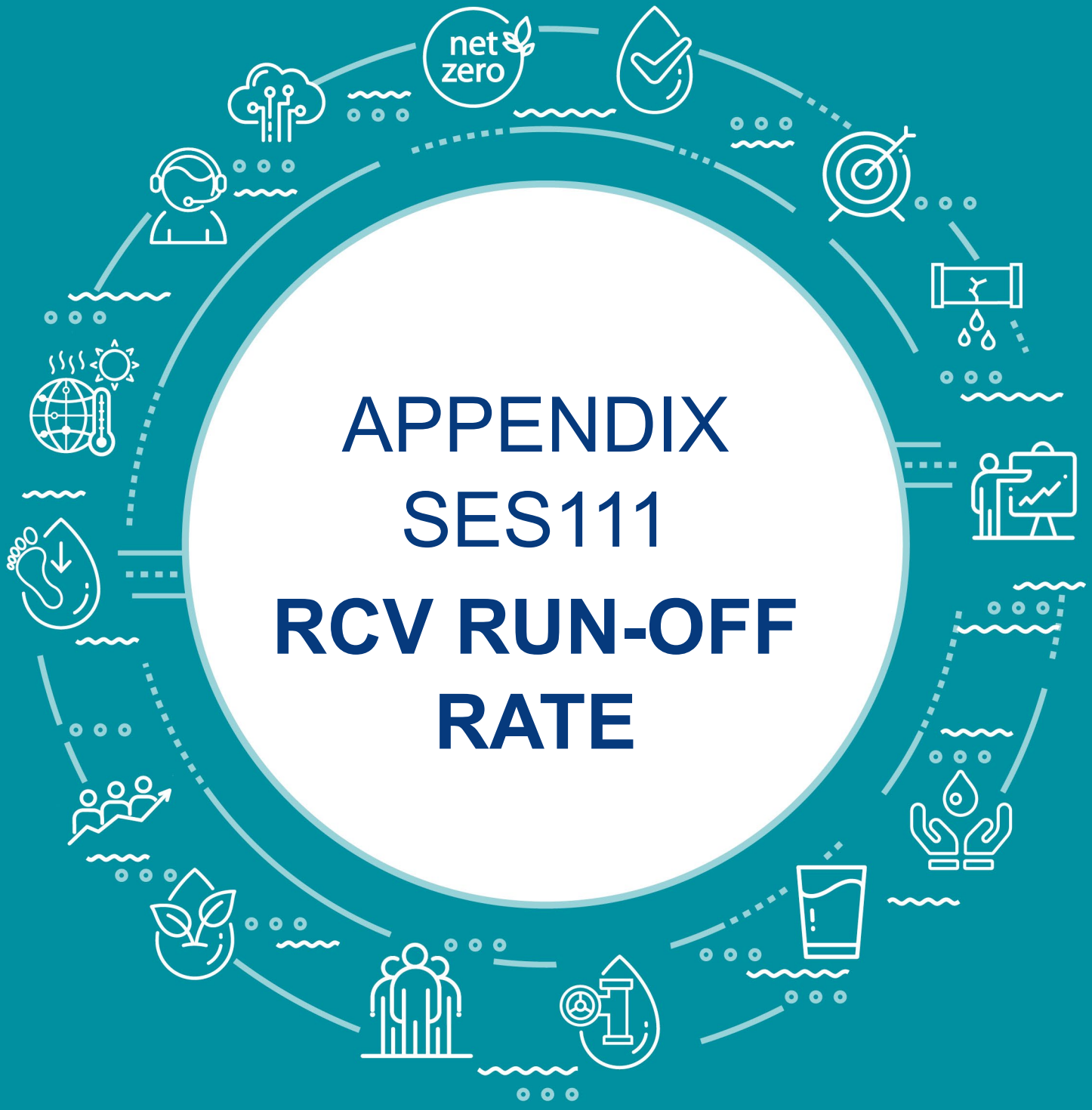
ses WATER



APPENDIX SES111

RCV RUN-OFF RATE

Contents

APPENDIX SES111: RCV RUN-OFF RATE

This representation provides further detail on, and justification of, our proposed RCV run-off rate of 7% for AMP8. To estimate our proposed RCV run-off rate, we took a renewals-accounting based approach, based on an analysis of the long-term average of our spend on capital maintenance and renewals. This approach was taken in recognition that our proposed PAYG rate did not include renewals expenditure, unlike other water companies.

Through its draft determinations, Ofwat is effectively asking us to reduce bills in the shorter term in exchange for materially higher bills in the longer term. This fails Ofwat's own intergenerational fairness test for the RCV run-off and PAYG rates and in turn, creates a financeability issue for us, as we will be required to finance this bill reduction over AMP8.

Notwithstanding our view that a 7% run-off rate remains appropriate in this context, we recognise that other companies in the sector recover maintenance and renewals expenditure through PAYG. If we were to adopt a similar approach for assessing PAYG, we are willing to accept lower RCV run-off rates closer to Ofwat's draft determination proposals. This alternative approach should address Ofwat's concerns around us being an outlier and provide greater alignment with the rest of the sector, while also addressing our concerns around financeability and the long-term bill affordability.

A. Introduction and Context

1. The RCV run-off allowance represents the recovery of previous investment held in a water company's Regulatory Capital Value (RCV). It was introduced by Ofwat in PR14 as part of the move towards a totex framework, where:
    - The Pay-As-You-Go (PAYG) rate represents the proportion of totex in any one year that is immediately recovered from charges levied on customers ("fast money"), while the remainder is added to the RCV to be recovered at a later date, and
    - The RCV run-off rate represents the proportion of the RCV – a measure of the outstanding capital provided by financial investors – that is 'amortised' each year and recovered from charges levied from customers ("slow money").
2. As is discussed below, the run-off of the RCV is one of the important building blocks of Ofwat's PR24 price controls.
3. It is important that decisions on a water company's PAYG and RCV run off rates are considered in the round given that it is the combination of 'slow' and 'fast' money that ultimately affects what customers pay for their water services and whether the level of revenue that is generated within a given AMP can be considered a fair and equitable rate of cost recovery from current and future customers.

4. In its PR24 final methodology, Ofwat provided guidance to water companies that their proposed RCV run-off rates needed to consider:[1]

   - **Intertemporal fairness,** i.e. that each generation of customers is paying their fair share for the assets they are benefiting from;
   - **Affordability,** i.e. the RCV run-off rate is consistent with maintaining affordable bills.
   - **Ofwat's guidance on upper limits,** which suggested that the run-off rates should be the lower of 4.5% and each company's run-off rate in PR19; and
   - **Financeability,** i.e. the RCV run-off rate balances both short-term and long-term financeability of the notional company.

5. At PR19 and PR24 many water companies have been moving towards a 'natural rate' for PAYG and RCV run-off. For the PAYG rate, which determines the recovery of fast money, this can be interpreted to be proportion of totex that comprises opex, although we observe that other companies also include infrastructure renewals expenditure (IRE) in this. For RCV run-off rate, which determines the recovery of slow money the definition is less clear, but Ofwat has previously defined it as: the "rate which reflects the economic reality of the expenditure which the company is incurring and the long-term nature of its investments."[2]

6. In our PR24 Business Plan, we proposed a run-off rate of 7% broadly consistent with the rate that was allowed by Ofwat at PR19. In its PR24 draft determinations Ofwat has instead adopted a run-off rate of 4.50% for our water resources (WR) price control and a rate of 4.15% for the water networks plus (WNP) price control.

7. The rationale stated for Ofwat's intervention, and the run-off rates it has adopted in the draft determination are as follows[3]:

> "We have intervened to reduce RCV run-off rates for SES Water. The company proposed RCV run-off rates for the water resources and water network plus of 7%, consistent with PR19 but significantly above other companies in the sector and our guidance on upper limits. An RCV run-off rate of 7% implies an average remaining life for long term assets of just 14.3 years, compared to an average of circa 25 years for the sector in our draft determinations, and would mean that 30% of the RCV existing at 31 March 2025 will be recovered by 2030.
>
> Maintaining RCV run-off rates at such a level over a number of price control periods may deplete the RCV and lead to financeability issues in the future, while placing increased cost on customers in the short term. The company sets out that if it changed its RCV run-off rate, an estimated £40 million additional funding would be required either through debt or equity. We are concerned that SES Water's business plan is proposing to continue a practice of using revenue from current customers to fund investments that will deliver improvements for future customers.
>
> We have set RCV run-off rates for our draft determinations at 4.50% for water resources and 4.15% for water network plus based on the lower of a rate based on historic cost depreciation and our upper limits."

8. As set out in the main body of our response to Ofwat's draft determinations,[4] we consider Ofwat's proposed intervention on the RCV run-off rate is not justified.

[1] Ofwat (2022) PR24 Final Methodology, Appendix 10: Aligning risk and return, p.53.
[2] See Ofwat in https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PAYG-model_SVE_FD.xlsx
[3] Ofwat (2024) PR24 draft determinations: Aligning risk and return appendix, p. 46
[4] SES Water (2024) Business Plan 2025 to 2030: Draft determination representation, SES101.

9. This appendix details our position on Ofwat's RCV run-off intervention. We demonstrate that, when combined with the PAYG rates in Ofwat's draft determinations for PR24, Ofwat's proposed RCV run-off rates for us in AMP8 would lead to:
    - An aggregate rate of cost recovery that does not provide us with the resources we require to undertake routine maintenance of the network;
    - Insufficient overall revenue being generated from current customers at the expense of future customers, and in doing so, violating Ofwat's own intergenerational fairness principle; and
    - The financial headroom introduced by Ofwat to support investment in improved outcomes, under a notional capital structure, being used to effectively require investors to subsidise a "run-off holiday" for customers.
10. Furthermore, as we show within this appendix, Ofwat's combined proposals on PAYG and RCV run off rates are not financeable on our actual financing structure. We consider the impact on our actual finances to be a relevant consideration to Ofwat's final determination because:
    - Our Business Plan aligned our proposed run-off rate of 7% with the rate that Ofwat itself allowed at PR19; and
    - The RCV run off rate is an important building block of the price around which companies structure their finances and so requires stability and predictability in regulatory policy between price reviews.
11. The rest of this representation is structured as follows:
    - Section C explains how we have thought about and approached the calculation of the RCV run-off in our PR24 Business Plan. It also explains why the issues identified by Ofwat in its draft determinations are largely an issue around the interactions between the RCV run-off rate and the PAYG rate, rather than us being an outlier relative to the rest of the sector;
    - Section D explains how the level of revenue generated in the next AMP implied by the 7% rate of run-off proposed in the Business Plan remains consistent with the criteria set out in Ofwat's final methodology;
    - Section E provides alternatives to the 7% run-off rate that would provide sufficient customer funding in the next AMP for long term capital maintenance and would address financeability issues with Ofwat's draft determinations; and
    - Section F provides concluding remarks.
12. For the reasons set out below, we continue to believe that a 7% run-off rate is consistent with Ofwat's PR24 methodology criteria and is in the interests of current and future customers in our area. However, this representation also provides alternative options that may also address the issues that have been raised by Ofwat and the strong concerns we have with the level of revenue that is generated by Ofwat's draft determinations based on its proposed PAYG and RCV run-of rates.
13. Should Ofwat consider those alternative options, we would ask to be provided with the opportunity to make further representations on the topic.

B. How has SES Water thought about its run-off rate?

Our proposed run-off rate is consistent with a renewals accounting approach.

14. The run-off rate that we proposed in the PR24 Business Plan, of 7%, was informed by the capital expenditure we require to maintain and replace the existing network and other infrastructure and non-infrastructure assets.

15. The formula we used is as follows:

$$Run - off\ rate = \frac{Spending\ on\ base}{RCV}$$

16. Here, base refers to routine capital expenditure to maintain our existing capabilities rather than enhancement expenditure to improve outcomes for customers.

17. Such an approach to estimating the 'natural' RCV run-off rate has a strong theoretical underpinning,[5] as it aligns with one of the main purposes of the RCV run-off – to allow water companies to generate the resources required to undertake capital renewals on the network. This allows the RCV to maintain a steady state over time before enhancements are accounted for. It is also recognised by Ofwat in its final methodology:

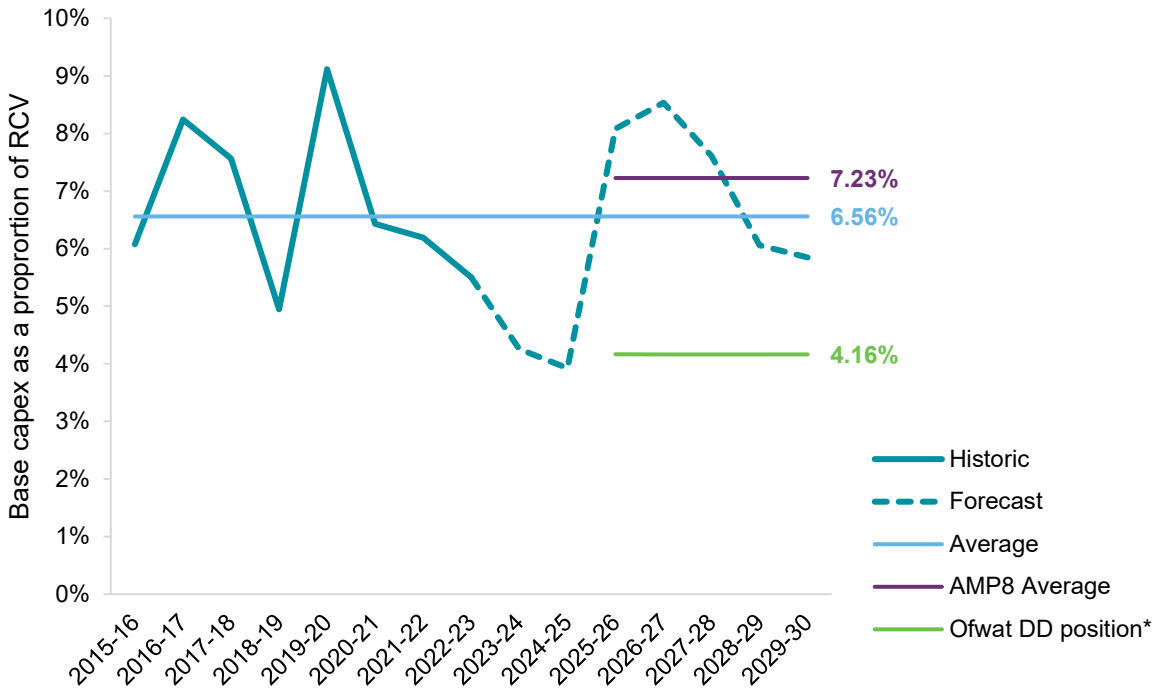
> "Typically, over the longer term we would expect the amount of revenue generated from customers in respect of the RCV run-off to be close to that required to be reinvested in new or replacement regulatory assets."[6]

18. An analysis of historic and planned base capital expenditure supports the 7% run-off rate that we proposed for PR24, as shown in Figure 1 below.

19. Figure 1 shows that over the 15-year period from 2015-16 (when the totex framework was first introduced by Ofwat) to 2029-30, we have spent and will spend an average of 6.6% of our RCV on base capital expenditure ('capital maintenance'). Looking at our plan for AMP8, we are expecting to spend an average of 7.2%.

[5] This approach can be considered an extension of renewals accounting. See Cave et al. (1994): ' Accounting for Regulation in UK Utilities – Centre for the Study of Regulation of Utilities' available here.
[6] Ofwat (2022) PR24 Draft Methodology, Chapter 8.

Figure 1: Historic and forecast SES Water 'natural' run-off rate using an expenditure-based approach.



Source: SES Water analysis of APR tables 4C and 4J and SES Water PR24 Business Plan forecasts
Note: Ofwat DD position is a weighted average of the WR run-off rate of 4.5% and the WN run-off rate of 4.15%.

20. The level and mix of base capital expenditure will vary on an annual basis given that capital maintenance spend is cyclical and can be lumpy, particularly for a small company like us. For example, in some years investment may be focused on major replacement projects (e.g. water treatment assets) while other years may involve more routine maintenance work. Given the cyclical nature of the investment it is therefore important a longer-term average is considered if using an expenditure (renewals) based approach to determining the appropriate run-off rate.

21. On this basis we proposed a 7% run off rate in our Business Plan, in line with the run-off rate assumed for us in prior AMPs. This rate is broadly consistent with the long-term trend and 15-year average of base capital expenditure and RCV in our Business Plan. Importantly, there is regulatory precedent to taking a renewals accounting approach to estimating rates of regulatory depreciation and cost recovery from customers. Ofwat used the assessment of renewals expenditure as a top-down sense check against the appropriateness of proposed depreciation of above ground assets under a 'broad equivalence test' used in PR99 through to PR09:

> "The costs of capital maintenance activity are reflected in price limits in different ways. Capital maintenance expenditure on infrastructure assets is not depreciated but is instead allowed for in price limits through an infrastructure renewals charge based on the fifteen-year average of infrastructure renewals expenditure.
>
> Capital maintenance expenditure on above ground assets is depreciated in the conventional way. However, as set out in previous publications, the Director considers

that in the long run such depreciation charges should be broadly equivalent to the actual capital maintenance expenditure on these assets."[7]

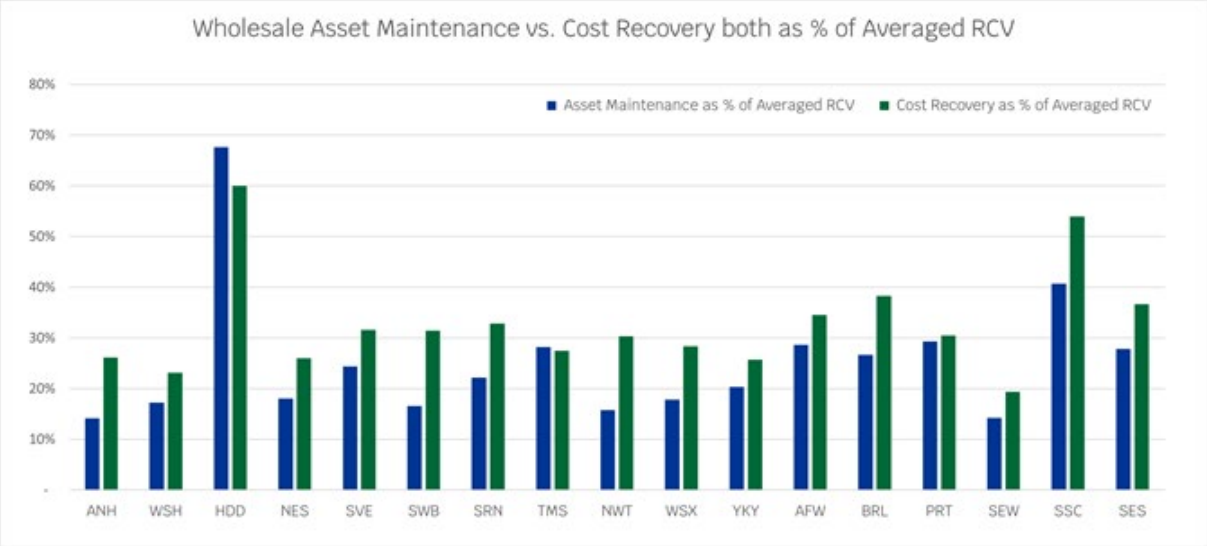
22. Such an approach is also used in Australia within the water sector.[8] Significantly, the approach was used to estimate our RCV run-off rate for both PR14 and PR19.[9]

Ofwat's concern that a 7% run-off rate would lead to a rapid depletion of the RCV is not supported by the evidence.

23. We recognise the concern reflected in Ofwat's draft determinations that a run-off rate that is consistently higher than the level of expenditure on maintenance and renewals, will likely lead to a substantial real terms reduction in the size of the RCV over successive price controls. This in turn risks the long-term financial resilience of a company by limiting its ability to withstand shocks.

24. Ofwat has claimed that water companies in England and Wales are spending less on maintaining the capability of the network than they have recovered through the RCV run-off. For example, Figure 2 below shows analysis in Ofwat's PR24 draft methodology comparing companies' asset maintenance spend as a percentage of the RCV to the rate of cost recovery of the RCV allowed in PR19.

Figure 2: Cost allowances for renewals and maintaining the asset base versus cost recovery at PR19 as a percentage of average RCV



Source: Ofwat (2022) PR24 Draft Methodology, Appendix 10 – Aligning risk and return, Figure 5.1

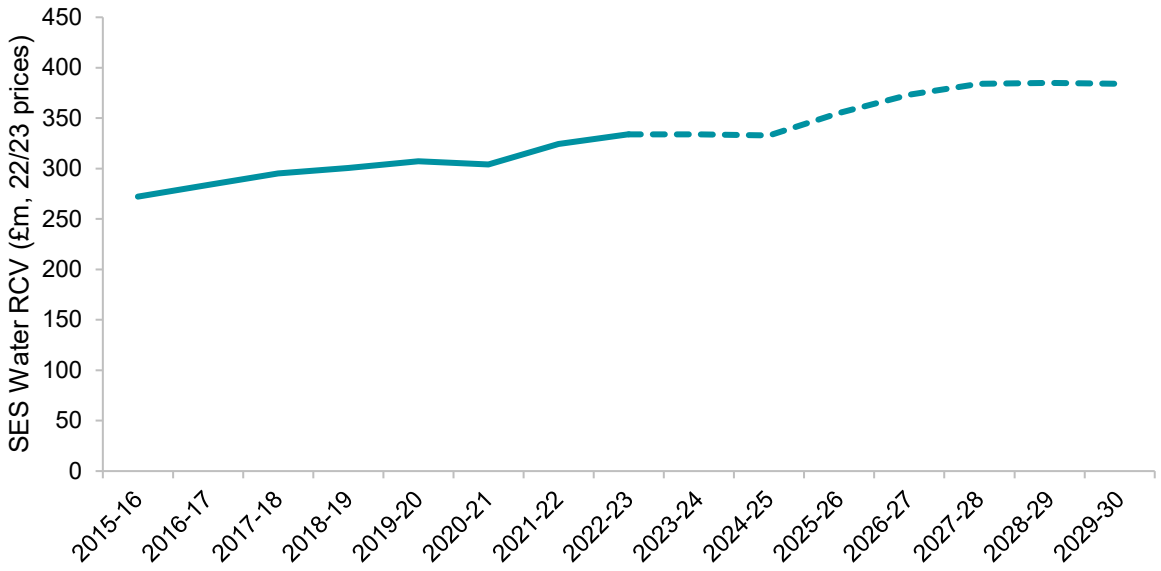
25. Figure 2 shows that for most companies in the sector, asset maintenance spend has been less than the assumed cost recovery rate in PR19.

26. However, as capital replacement activities are cyclical, it is more appropriate to assess this over a longer period than the five-year period considered. Historically, for below ground activities, Ofwat used expenditure averaged over 15 years to estimate regulatory depreciation rates.[10] And as shown in Figure 1, our historic and planned expenditure over the 15-year period from 2015-16 is consistent with a 7% run-off rate.

[7] Ofwat (1999) Final Determinations, Future water and sewerage charges 2000-05, Chapter 7.
[8] Queensland Competition Authority (2014) Issues in the Application of Annuities.
[9] Ofwat (2019) PR19 final determinations, SES Water – Allowed revenue appendix.
[10] See https://www.ofwat.gov.uk/wp-content/uploads/2018/08/FOI-20180660.2.pdf

27. In its draft determinations, Ofwat also notes that a 7% run-off rate would mean 30% of the RCV at the start of AMP8 would be recovered within the AMP. The suggestion is that continuing with a 7% run-off rate may rapidly deplete the RCV. However, as we demonstrate earlier, the 7% run-off rate is our natural rate given our PAYG rate; any run-off reduction in the RCV is offset by additions to the RCV from our capital maintenance activities.
28. We can also observe this from our historic and forecast RCV values. Figure 3 below shows our actual and forecast real RCV (in 2022/23 prices) as set out in the PR24 Business Plan.

Figure 3: SES Water real RCV from 2015/16 onwards.



Source: SES Water analysis of APR tables
Note: The forecast RCV, shown in dashed line, is calculated in line with our PR24 Business Plan submission, which includes a 7% RCV run-off rate.

29. Figure 3 shows that our RCV has increased by 23% in real terms (£62m in 2022/23 prices) over the eight years from 2015/16 to 2022/23 and is expected to continue to grow over the AMP8 period (the forecast period). Over the same period, our enhancement expenditure totalled £55m in 2022/23 prices, meaning that our RCV has remained relatively stable in real terms over this period once the effect of enhancements has been removed.
30. This implies that historic usage of a 7% run-off rate has not resulted in a depletion of the RCV, nor has it resulted in excess returns. In fact, it suggests that the run-off rate has been broadly right with the base value of the RCV remaining broadly stable, implying that the slow money recovered through the RCV run-off rate has matched the expenditure on capital maintenance and renewals.

Ofwat's proposed approach to estimating the run-off rate is imperfect and does not reflect our approach to accounting for infrastructure maintenance and renewals.

31. For PR24, Ofwat has suggested that the RCV run-off rate "*is best informed by a consideration of average remaining lives of the assets utilised in each control to provide*

the services to customers, while ensuring that companies have sufficient resources to maintain the capability of their assets."[11]

32. Ofwat has suggested using the following formula to estimate the run-off rate:

$$Run\ off\ rate = \frac{Depreciation\ charge}{Net\ book\ value}$$

Where:

$$Average\ remainng\ asset\ life = \frac{Net\ book\ value}{Depreciation\ charge}$$

33. In its draft determinations, Ofwat has set our run-off rate at 4.50% for water resources and 4.15% for water networks plus.[12] This is based on an analysis of historic cost depreciation based on the formula above, as well as Ofwat's guidance on upper limits. The upper limit itself is defined by reference to sector wide historic cost depreciation.

34. There are several drawbacks of this approach:

- Where assets are fully depreciated in accounting terms, but are still operational and require ongoing maintenance, such an approach will likely underestimate the run-off required to maintain the capability of the network;
- The approach is highly sensitive to accounting assumptions around the depreciation of assets or condition of assets, which does not always reflect the operational reality. For example, where part of a pipeline is repaired or replaced, treating the replacement / repair as a new asset would lead to a lower depreciation charge than treating it as part of the existing asset;
- The use of historical cost accounting unduly weighs historic investments in long-lived assets, as the cost of replacing such assets will likely be much higher than the cost as captured within the (historic) net book value;
- The digital assets that we have invested in in recent years as part of our investment in a 'smart network', which have a shorter asset life, are only now beginning to be captured in the asset life calculations; and
- The approach does not account for differences between companies in whether infrastructure renewals are treated as capex or opex. All else being equal treating infrastructure renewals as capex would be reflected in having lower PAYG rates, which would need to be compensated through higher run-off rate. This is explored in more detail in the next section.

35. More generally, the approach diverges materially from the approach Ofwat took for PR19 and PR14, where a mixture of the renewals accounting and asset lives approaches were used. In PR19, Ofwat used a renewals accounting approach for setting our run-off rate.

> "For the draft determination, we applied SES Water's RCV run-off rates which are based on recovering an amount equivalent to capital maintenance changes. SES Water does not make any representations in relation to RCV run-off rates, and we continue to apply the company's RCV run-off rates for the final determination."[13]

36. It is important to remember that the objectives of the run-off rate are to provide:

- The return of capital invested in the business according to a profile that matches the lives of the assets it has been invested in[14]; *and*

[11] Ofwat (2022) PR24 Final Methodology, Appendix 10: Aligning risk and return. p.52
[12] Ofwat (2024) PR24 draft determination Aligning Risk and Return: Appendix 1. p.46
[13] Ofwat (2019) PR19 final determinations: SES Water final determination, p.49.
[14] To match cost recovery with the receipt of benefits from investment by customers.

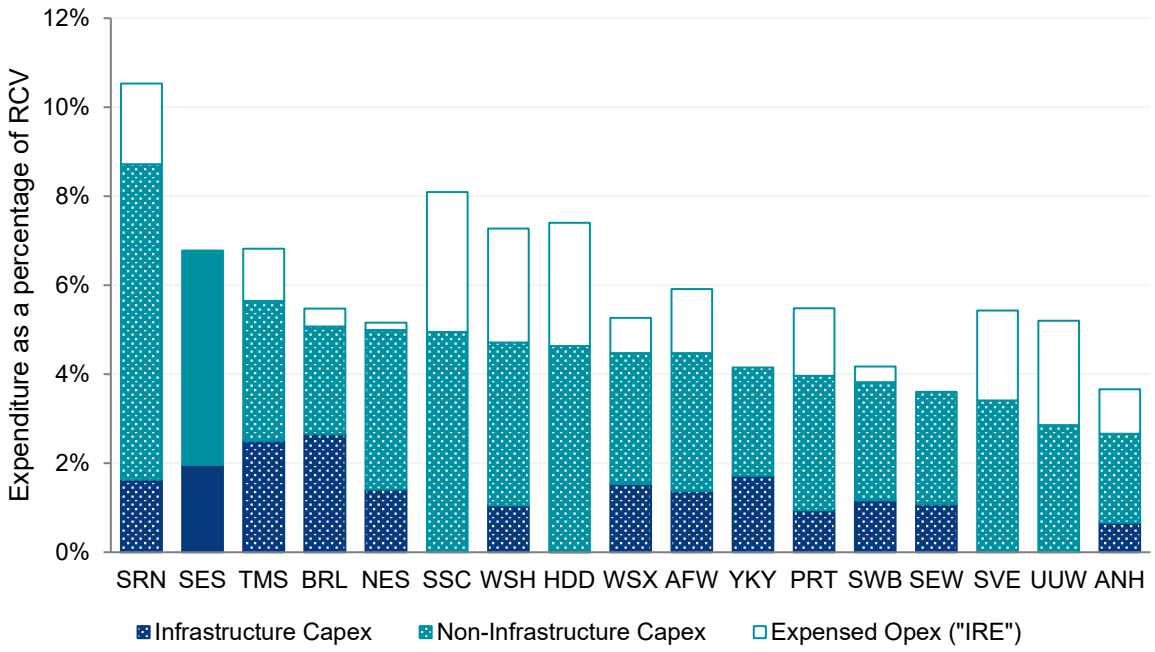
- Sufficient funding over time matches the expenditure incurred by the company to maintain its system of assets – the renewals concept.

37. The natural rate of RCV run-off should combine these two aims and in a position of steady state they should not be conflict. But the limitations with the historical depreciation approach which has largely informed Ofwat's draft determinations, alongside Ofwat's proposed treatment of infrastructure renewals in our specific case, risks Ofwat's price controls not achieving these twin aims for us.

SES Water's required higher run-off rate largely reflects the treatment of its renewals expenditure.

38. We are aware that we are one of the few companies that account for all our infrastructure renewals expenditure as capex, within the APR. We also note that other companies routinely expense much of their renewals expenditure as opex (i.e. as IRE), as shown Figure 4 below.

Figure 4: Wholesale water base renewals expenditure as a proportion of the RCV, average from 2015/16 to 2022/23



Source: SES analysis of APR data and Ofwat RCV data

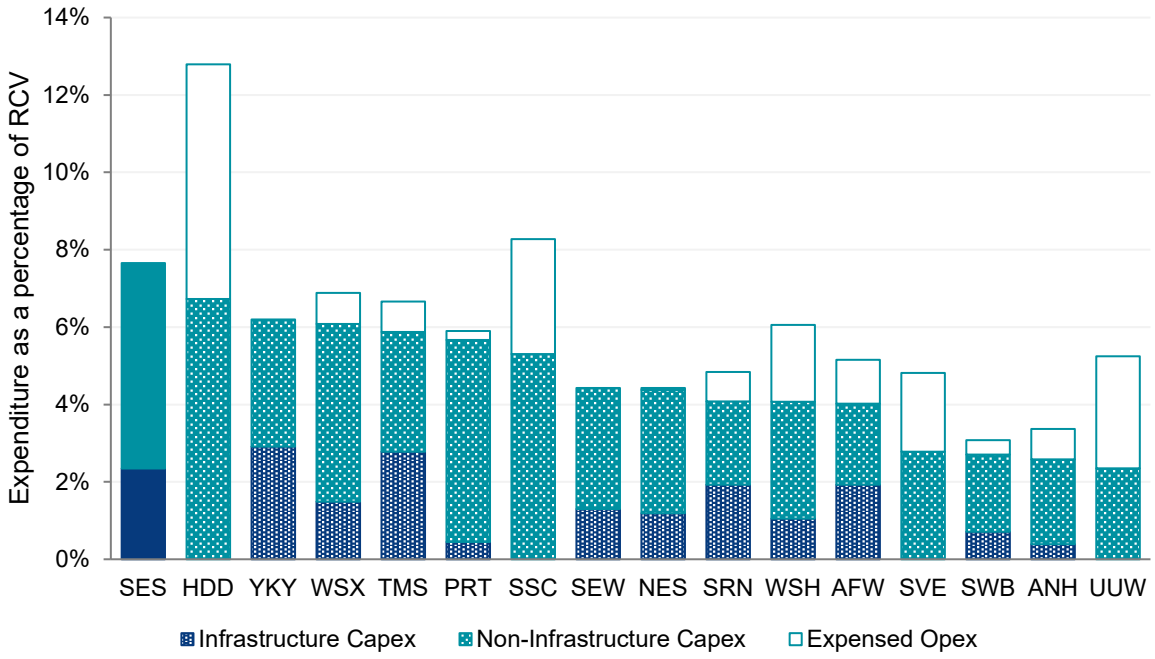
39. Figure 4 shows that over the eight-year period from 2015/16 to 2022/23, we are a relative outlier, in terms of the volume of capital maintenance and renewals activity we have undertaken and not recovered through opex. Once the volume of renewals activity that is expensed as IRE is excluded, only Southern Water have spent more in base capex ('capital maintenance') as a proportion of their RCV than we have.

40. Over the period shown in the figure, spending classed as IRE on average represented 1.4% of company RCVs (excluding us). This explains a large proportion of the gap between the historic RCV run-off rates used for other water companies versus the 7% that we have used. In simple terms, we have historically maintained a similar aggregate cost recovery rate as other water companies (when the impact of 'slow' and 'fast' money

recovered from customers is considered in combination), but we have achieved this by maintaining a 'relatively higher' run-off rate and a 'relatively lower' PAYG rate.

41. We note that many companies are proposing to continue recovering IRE through PAYG for PR24, with Affinity Water and South West Water proposing to also recover 'capitalised IRE' through PAYG.[15] The figure below shows that SES Water is one of the few companies not expensing any renewals activity through IRE (and through PAYG), despite proposing comparably higher levels of renewals activity.

Figure 5: Wholesale water base renewals expenditure as a proportion of the RCV, average from 2025/26 to 2029/30, company business plans



Source: SES analysis of PR24 company business plans

42. We also observe that Ofwat has accepted the approach adopted by other companies as consistent with its PR24 methodology.

> "We accept that recovery of infrastructure renewals spend is consistent with the PR24 methodology whether this is recovered through PAYG or capitalised and recovered through RCV run-off rates over time.
>
> Therefore we accept the proposals put forward by Affinity Water and South West Water to include infrastructure renewal expenditure within PAYG."[16]

43. Our 7% RCV run-off rate is largely consistent with an aggregate rate of cost recovery adopted by other water companies once the approach other companies take to the recovery of infrastructure renewals through PAYG is taken into consideration.

44. Based on our Business Plan submitted totex, Table 1 below compares the revenues that we would collect if the full amount of requested totex was approved, but under different RCV run-off rate and PAYG rate options. It shows that recovering planned renewals expenditure through PAYG would lead to very similar bills and levels of revenue recovery.

[15] Ofwat (2024) PR24 Draft Determination Aligning Risk and Return: Appendix 1. p.30. We assume references to capitalised IRE relates to base infrastructure capex.
[16] Ofwat (2024) PR24 Draft Determination Aligning Risk and Return: Appendix 1. p.31.

Table 1: Revenue and bill impact of expensing renewals expenditure through RCV run-off rate versus PAYG rate

	Total revenue over the AMP (£ million, 2022-23 prices)	Average bill (£, 2022-23 prices)
7% run-off rate PAYG rates excluding IRE	432.2	235
4.5% and 4.15% run-off rates PAYG rates including IRE	427.8	232

Source: SES analysis
Note: Uses totex values in line with our revised Business Plan submission

45. It is the aggregate rate of cost recovery and its impact on customer bills, i.e. considering the recovery of 'slow' (run-off) and 'fast' (PAYG) money in combination, that must be used to assess whether the level of revenues recovered from customers within an AMP is intergenerationally fair.

46. Ofwat has concluded that we are an outlier in the sector on its RCV run-off rate but does not appear to have accounted for us also being an outlier in our approach to and treatment of IRE in the determination of its PAYG rate.

47. Ofwat's proposed intervention on RCV run-off, alongside the proposed PAYG ratios in its draft determinations, would result in a level of revenue generated from our customers that is below the long-term average rate of capital maintenance spend, and therefore, the funding that is needed to maintain the capability of the network.

48. Ofwat's current proposals on RCV run off and PAYG – when considered in combination, i.e., as aggregate rate of cost recovery from customers – would not achieve the aim of them being set to a 'natural rate' that, in Ofwat's own words, are required to be reinvested in new or replacement regulatory assets.

C. How does SES Water's proposed run-off align with Ofwat's criteria?

Intergenerational equity

49. Our proposed RCV run-off rate has been designed to ensure that we can fund routine maintenance on the network to maintain our capabilities. As noted in paragraph 42, Ofwat has accepted that it is intergenerationally fair for current customers to fund capital maintenance and infrastructure renewals spend. Given differences in how different companies allocate capital maintenance and renewals spend to PAYG, if at all, it is essential that the PAYG and run-off rates are determined jointly.

50. Ofwat has not done this in its draft determination. As our proposed PAYG rate excludes capital maintenance and renewals activity, a run-off rate of 4.5% would lead to an ever-increasing RCV. This would in turn lead to future customers having to fund both current and future maintenance and thus, failing Ofwat's intergenerational fairness test.

51. As the analysis presented in paragraphs 44 to 46 demonstrates, the run-off rate we propose relates less to current customers paying for services benefiting future customers, and more to whether spending on renewals is recovered through a higher run-off rate or a higher PAYG rate.

Affordability

52. In our Business Plan, we assessed affordability on an overall basis, using a range of levers to ensure bills remained affordable within AMP8 and beyond. Significantly, our proposed bill increase over AMP8 was among the lowest in the sector. This is because we challenged ourselves to put forward an ambitious plan by including stretching efficiency targets. The PR24 Business Plan also included adjustments to smooth bill increases over AMP8, particularly given recent inflationary bill increases.

53. We consider these levers more appropriate for managing the affordability of bills than an adjustment to the RCV run-off rate. Stepping down the run-off rate from 7% to 4.5% would lead to a short-term reduction in bills by introducing a temporary run-off holiday. This would reduce bills by over £50m over the AMP but would come at the expense of bills in the longer term as this sum would be retained within the RCV. With the RCV increasing real terms over time, this risks long-term affordability.

Consistency with upper limits

54. We recognise that the upper limits proposed by Ofwat have been informed by an analysis of historical depreciation charges. This is a deviation from Ofwat's historical approach of allowing the RCV run-off rate to be based on rates of spending on renewals. As shown in the previous section, our proposed run-off rate is an alternative to expensing renewals through PAYG, resulting in a broadly equivalent impact on revenues. As such we consider that the RCV run-off rate achieves the purpose of Ofwat's guidance on upper limits, even if not strictly compliant with them.

Financeability

55. The RCV run-off and PAYG rates proposed by Ofwat in its draft determinations creates financeability issues both under a notional and an actual capital structure.

56. The combined recovery rate through run-off and PAYG will require us to finance not just our enhancement activity but also routine maintenance activity through our balance

sheet. This is at a time when we have proposed, and Ofwat has accepted, an ambitious plan for delivering improved outcomes for our customers.

57. Ofwat has recognised our need to raise significant amount of external equity to finance this ambitious plan and has aimed to create sufficient financial headroom to enable this additional investment. However, by stepping down the run-off rate from the level required to fund routine capital maintenance, Ofwat is requiring us to raise additional equity to finance a temporary run-off holiday.

58. This can be observed from Ofwat's own financeability modelling of its draft determinations:

    (a) The draft determinations assume £43.7 million (nominal) in enhancement totex over AMP8, of which £35.7 million is capex.

    (b) Over the same period, Ofwat is assuming £28.1 million of external equity injections plus a reduction in the dividend yield to 2%.

    (c) Assuming this enhancement totex is financed at a gearing ratio of 55% would imply £19.7 million of additional equity, significantly lower than the £28.1 million actually required. This £8.4 million difference, plus the additional equity retained through a reduction in the dividend yield, is the residual required to finance the temporary run-off holiday.

59. Ofwat's proposals on the RCV run-off rate also create a financeability issue under both a notional and actual capital structure basis, by changing from the long-term precedent around the nature of the run-off rate. We have structured our finances around being able to recover the cost of routine capital maintenance through the run-off rate, i.e. being able to use a renewals accounting approach to estimate regulatory depreciation. Requiring a step-down from the rate we have used for the last two AMPs inevitably creates a financeability issue.

60. In the table below, we show the impact of moving from a 7% RCV run-off rate to the run-off rates proposed in the draft determinations.

Table 2: Summary of SES Water's financial health with higher and lower RCV run-off rates, under a notional capital structure

	25/26	26/27	27/28	28/29	29/30
SES BP submission (RCV run-off rates: 7.00% WR, 7.00% WN+)					
Income (£m, nominal)					
Appointee allowed revenue	75.78	90.09	90.95	87.44	87.94
Ratios					
AICR	2.084	1.849	1.831	2.070	2.168
FFO / net debt	16.23%	14.97%	14.36%	14.89%	14.81%
Appointee Gearing	56.15%	58.51%	61.22%	62.37%	63.36%
Balances (£m, nominal)					
Total debt	211.8	237.8	263.3	275.8	287.8
Equity injected	20.0	5.0	-	-	-
RCV	377.2	406.5	430.1	442.2	454.1
Ofwat DD position (RCV run-off rates: 4.50% WR, 4.15% WN+)					
Income (£m, nominal)					
Appointee allowed revenue	66.03	80.64	81.80	78.83	80.01
Ratios					
AICR	2.025	1.823	1.915	2.212	2.367
FFO / net debt	10.66%	9.58%	9.26%	9.72%	9.69%
Appointee Gearing	56.42%	59.82%	63.22%	65.02%	66.53%
Balances (£m, nominal)					
Total debt	240.7	245.6	251.4	257.8	264.7
Equity injected	20.0	5.0	-	-	-
RCV	388.1	428.7	464.2	488.5	512.7

Source: SES Water analysis
Note: The allowed revenue figures here are in line with our revised Business Plan submission.

61. The allowed revenue resulting from the RCV run-off and PAYG rates in Ofwat's draft determinations, brings in around £33 million (nominal) less than the 7% run-off rate we have proposed. This results in our revenues being insufficient to cover our operating expenditure and financing costs.

D. Potential alternatives to our proposed run-off rate

62. We maintain that a 7% run-off rate is appropriate in the context of how much it spends on routine maintenance each year. However, there are potential alternatives that could present a viable solution to the financeability issue introduced by using the lower run-off rates proposed in the draft determination.

Recovering proposed renewals expenditure through PAYG and maintaining a lower run-off rate.

63. An alternative to recovering our routine maintenance expenditure through the RCV run-off rate would be to recover it through PAYG, by including capitalised IRE in the estimate of PAYG.

64. As noted earlier, many companies routinely expense some or all renewals expenditure as opex. Over AMP8, Hafren Dyfrdwy, South Staffs Water, United Utilities, Severn Trent Water, Affinity Water, and South West Water, are proposing to recover all renewals expenditure through PAYG, either by expensing renewals expenditure through IRE or by including capitalised IRE in the PAYG rate calculation. Ofwat has accepted the approach taken by each of these companies.

65. The table below shows the impact adopting a similar approach would have on our run-off and PAYG rates, while Table 1 presented earlier shows the impact this would have on revenues and on bills. While this would mean that our PAYG rate for Water Resources is the highest in the sector, this reflects our greater exposure to power costs given the pumping requirements in the area that we serve.

Table 3: Impact of expensing renewals expenditure through RCV run-off rate versus PAYG rate

		Recovering renewals expenditure through RCV run-off	Recovering renewals expenditure through PAYG
Water Resources	RCV Run-off rate	7.00%	5.05%
	PAYG rate	88.2%	92.8%
Water Networks Plus	RCV Run-off rate	7.00%	4.70%
	PAYG rate	50.7%	63.0%

Source: SES Water analysis

66. We recognise that recovering such expenditure through PAYG would bring our approach in line with the rest of the sector. And as Ofwat has accepted this approach for other companies in its PR24 draft determinations, we consider that this approach would be acceptable. As such, we consider this a suitable compromise for dealing with our financeability concerns under both a notional and actual capital structure, as it would allow us to continue to recover our maintenance and renewals expenditure through the revenue generated in the AMP.

67. In the table below, we show the impact of this PAYG adjustment on our financeability under an actual capital structure.

Table 4: Summary of SES Water's financial health with lower RCV run-off rates but higher PAYG rates, under a notional capital structure

	25/26	26/27	27/28	28/29	29/30
Recovering renewals expenditure through PAYG					
Income (£m, nominal)					
Appointee allowed revenue	77.21	95.90	93.50	84.61	85.04
Ratios					
AICR	3.637	3.963	3.404	2.972	3.113
FFO / net debt	17.08%	18.28%	16.11%	14.17%	13.94%
Appointee Gearing	56.10%	58.20%	60.40%	61.39%	62.72%
Balances (£m, nominal)					
Total debt	309.0	327.8	345.6	356.1	366.1
Equity injected	20.0	5.0	-	-	-
RCV	389.1	415.2	436.0	451.5	467.4

Source: SES Water analysis

Gradually transitioning to a lower run-off rate.

68. Our proposed run-off rate of 7% is based on Ofwat's historic regulatory practice, as described in paragraph 21. While Ofwat is now of the view that basing the RCV run-off rate on an assessment of asset lives as estimated by historical cost depreciation is more appropriate, this is a change from its historic position. As such, regulatory best practice would dictate that Ofwat implements transitional arrangements given the impact of this change on our financeability.

69. There is regulatory precedent for this. When Ofgem introduced new asset life assumptions as part of RIIO-1, it recognised that transitional arrangements may be required even if those new asset life assumptions applied to new investments only.[17] As such, Ofgem invited companies to demonstrate whether further transitional arrangements would be required to ensure financeability.

70. A gradual transition to the run-off rates proposed in the draft determinations may provide an alternate solution to the financeability challenge created by the change in run-off rate. We consider this approach to be less preferable than an adjustment to the PAYG rate. However, we are open to engaging constructively with Ofwat should it consider pursuing this option, to agree appropriate transitional arrangements.

[17] https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/assetlivedecision_0.pdf

E. Concluding remarks

71. Our proposed run-off rate of 7% is supported by renewals accounting practice, Ofwat's own regulatory precedent and by an empirical analysis of our long-term average expenditure on capital maintenance and renewals.

72. Ofwat's proposal to step-down the run-off rate to 4.5% for WR and 4.15% for WNP is inappropriate for three reasons:

    (a) It stops us from being able to fund routine capital maintenance and renewals expenditure incurred over the AMP, through in-AMP customer bills. It appears that Ofwat has looked at our RCV run-off rate in isolation and not considered it in combination with our proposed PAYG rate. And so, while Ofwat has accepted that routine maintenance and renewals expenditure can be recovered from current customers through a higher PAYG rate, it is denying us the ability to recover the same expenditure through a higher-run-off rate.

    (b) It temporarily reduces bills for current customers at the expense of higher bills for future customers. By introducing a temporary run-off holiday, Ofwat has been able to substantially reduce bills. However, this will mean future customers paying for both current and future routine network maintenance. This fails Ofwat's own intergenerational fairness test and creates long-term affordability risks.

    (c) It requires us to finance routine maintenance and renewals expenditure on its balance sheet, which can only be done by raising significant new equity. This equity, while intended to be used to invest in improving outcomes for customers, will instead need to be used to finance the run-off holiday.

73. While we continue to maintain the appropriateness of a 7% run-off rate, we are willing to consider alternatives that achieve a similar outcome in terms of financeability. We recognise that the alternative of recovering renewals expenditure through PAYG would create greater alignment with the rest of the sector and we are open to discussing such an approach with Ofwat.