APPENDIX SES112

RISK AND RETURN AND FINANCING OUR PLAN

Contents

APPENDIX SES112: RISK AND RETURN (RORE) AND FINANCING OUR PLAN

This representation makes the case for why Ofwat's draft determination package presents us with a significantly downward skew in the balance between risk and reward. The current package of measures presented in the draft determination creates a very likely risk that we would fail to earn an equity return over AMP8.

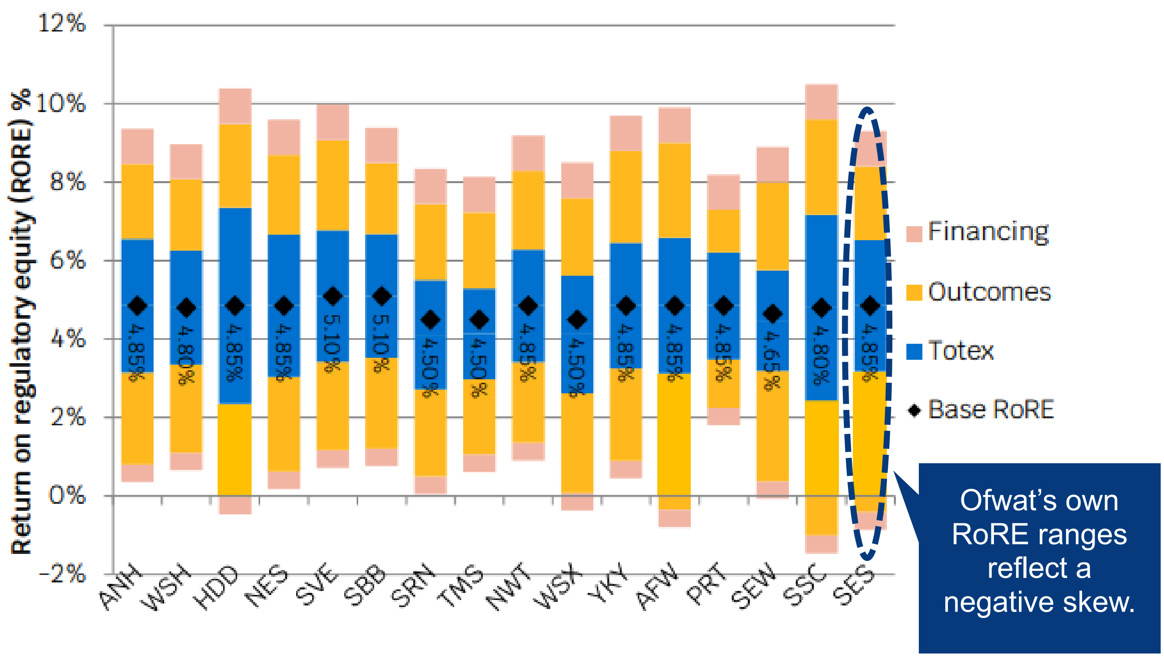
We consider that this can be materially remedied through targeted, but significant changes to the package of Outcome Delivery Incentives, Price Control Delivery incentives, cost allowances, and uncertainty mechanisms. Should our representations on these issues be accepted, the residual balance between risk and reward will remain slightly negatively skewed but will present an overall package that we can find acceptable.

A. Introduction

1. Ofwat states in its draft determinations that it has "carefully considered the risk that an efficient company may face in the 2025- 30 period." Ofwat also suggests that it has "put in place a package of incentives, cost allowances and uncertainty mechanisms" such that "the risk is broadly balanced".[1]
2. In contrast, our PR24 business plan concluded that the balance of risk and reward in Ofwat's price controls was negatively skewed, driven in particular, by Ofwat's proposed Outcome Delivery Incentive (ODI) package. Our conclusions, prepared prior to Ofwat's draft determinations, were driven both by the stretching ambitions and performance targets reflected in our plan, and by how we expected Ofwat may set the PR24 company-specific and common Performance Commitment Levels (PCLs). Of particular focus were the likely PCLs for Per Capita Consumption (PCC) and business demand, where our outturn performance is not fully within our control.
3. Having reviewed Ofwat's draft determinations, we conclude that without targeted, but significant changes to the package of ODIs, Price Control Deliverables (PCDs), cost allowances and uncertainty mechanisms, there will be a significant imbalance between the degree of risk and reward we are exposed to. We are very concerned with the level of negative skew in the balance of risk and reward arising from Ofwat's draft determination proposals.
4. This negative skew is apparent from Ofwat's own draft determination risk ranges, as illustrated in Figure 1 below.

[1] Ofwat (2024): 'PR24 draft determinations: Aligning risk and return appendix', p. 6.

Figure 1: Ofwat PR24 draft determination risk ranges[2]



Source: Ofwat (SES Water adapted)

5. This figure shows that on Ofwat's own assessment, our risk ranges are negatively skewed, and that we are amongst the water companies most exposed to downward risk across the sector. This is before any consideration is given to factors that impact Return on Regulated Equity (RoRE) risk which we consider are not adequately captured in Ofwat's draft determination assessment.
6. This representation details our concerns with both the expected equity return (i.e. central case) and the RoRE risk ranges we consider are implied by Ofwat's draft determinations. We also set out how Ofwat can address these issues in its final determinations to bring the PR24 package back into balance. The rest of this representation is structured as follows:
   - **(a)** In Sections B to E, we set out the factors that contribute to our conclusion that Ofwat's draft determination results in a negatively skewed balance between risk and reward, and that its assessment of our RoRE risk ranges provides an overly positive presentation of the actual risk that is embedded within the draft determinations;
   - **(b)** In Section F, we set out our updated view of RoRE risk ranges if Ofwat addresses the issues raised in our representations; and
   - **(c)** In Annex A, we compare the PCDs proposed in our business plan against the ones Ofwat has proposed in its draft determination.

[2] Based on additive P10 and P90 ranges, calculated as a percentage of regulatory equity.

B. Outcomes

ODI rates, caps and collars

7. As we discuss in Appendix SES102: Outcomes, we recognise that Ofwat has adopted a top-down approach to calculate an appropriate ODI rate for each Performance Commitment (PC). We acknowledge that this approach enables Ofwat to transparently and consistently calculate common ODI penalties and rewards across the sector.

8. However, we consider that this approach as implemented in the draft determinations, fails to account for company-specific circumstances for several PCs. There are several cases where Ofwat has taken an overly mechanistic approach and not accounted for the different circumstances of water-only companies (WoCs), which has resulted in ODI rates that are disproportionate to the impact on the customer.

9. While we provide further detail in Appendix SES102: Outcomes, we summarise the key issues below:

   - Delivery of our P10 performance forecast for **Discharge Permit Compliance** (equivalent to just one site failure per year) would result in a pre-tax penalty of £13.9 million per annum and a pre-tax penalty of £69.5 million (equivalent to around 6.3% RoRE) over AMP8. This is clearly disproportionate to the goal of the ODI and is our highest priority issue for Ofwat to address in its final determinations.

   - Similarly, the approach that Ofwat has taken to set the ODI rate for **Water Quality Contacts** results in a disproportionate ODI rate given our level of performance. We estimate that the revised ODI rate would mean that we receive a penalty of approximately £7,000 for every customer contact that exceeds the already stretching level of industry leading performance that we currently achieve in this PC area. The proposed ODI rate, combined with us being set the second strongest PCL for Water Quality Contacts in the sector, contributes to our assessment that Ofwat's draft determinations would not allow us to earn our cost of capital as a base case.

10. We also note that Ofwat has rejected the proposals in our business plan to introduce caps and collars or deadbands on several ODIs, including PCC, Discharge Permit Compliance and Serious Pollution Incidents. Nothing in Ofwat's draft determinations leads us to conclude that the inherent risk and uncertainty in these PCs which led us to propose these uncertainty mechanisms has gone away.

11. This, therefore, further contributes to our assessment that the inherent risk in the ODI draft determinations package is unbalanced, and more risk extenuated, than in Ofwat's assessment. This is because of factors such as:

    (a) The potential swings in overall non-household demand to external economic drivers in our supply area (which led us to propose a deadband of +/- 1.5% around the performance commitment level in our business plan); and

    (b) Ofwat's decision not to include a cap and collar on PCC when this remains a PC that is subject to considerable uncertainty, not least because the stretching targets Ofwat has proposed, rely on actions from government as well as SES Water.

12. We have not made representations for Ofwat to reconsider its decision not to adopt the caps and collars we originally proposed in our business plan. Nevertheless, they remain issues that need to be considered in taking an 'in the round' assessment of the balance of risk and reward at PR24 and should be assessed on a standalone licensee basis and without expectation of our positioning in the Pennon Group in AMP8.

PCLs

13. We welcome that Ofwat has recognised the ambition in our PR24 business plan as reflected in its QAA assessment.

14. Notwithstanding this, we note that Ofwat has strengthened the PCLs for several important PCs, contributing to an additional stretch in the ODI package compared to our business plan. In some cases, as we demonstrate further on, Ofwat's proposed PCLs increase the risk of us not earning our allowed rate of return even if we were to achieve our business plan targets (at upper quartile industry performance).

15. We consider these changes from our business plan contribute to an expectation of a negative skew in the RoRE risk ranges for reasons detailed below.

Customer contacts on water

16. We are proud to operate at an upper quartile performance level for Water Quality Contacts. Our PR24 business plan set out that we would deliver a performance of 0.6 contacts per 1,000 people which is a performance level that is less than half of the sector average. Ofwat's draft determination PCL of 0.5 contacts per 1,000 people represents a further stretching target beyond this upper quartile level.

17. As we discuss in Appendix SES102 we do not consider that Ofwat's decision to strengthen this target is justified. While the PCL exit target for AMP7 was set at 0.5, our outturn level of performance over the AMP has been closer to 0.6, owing to reduced barriers for customers contacting us and a more conservative approach to recording contacts that partly relate to taste, odour and appearance issues. Importantly, these factors do not reflect a deterioration in our performance on the taste, odour and appearance of the water we serve our customers, and our outturn PC performance in this AMP remains at upper-quartile level. Ofwat's proposals mean that we expect to be penalised for maintaining an upper-quartile performance in this PC, even before any account is taken for further downside risk (e.g., further deterioration at the P10 level).

18. We also do not agree with the implicit assertion that we have been funded to achieve the PCL exit target for PR19. We note that we had not been provided any enhancement allowance for this target. And we also detail in Appendix SES102: Outcomes, why a PCL of 0.6 in AMP8 ought to be considered equivalent to the PCL of 0.5 used in previous AMPs.

19. Overall, the increase in stretch beyond what can realistically be considered achievable at a P50 level, results in an ODI RoRE risk that is negatively skewed for this PC.

PCC and business demand

20. We note that Ofwat has increased the stretch of the PCLs on PCC and business demand. As we discussed within our PR24 Business Plan, we are committed to a high level of ambition in PCC and business demand reduction. [3] But we also believe that targeted risk mitigations are needed to manage the inherent risks in achieving this ambition.

21. Performance improvements in these areas rely on actions of others that are outside of our control and are subject to considerable uncertainty. PCC, for example, is affected by shifting customer behaviour while business demand will be influenced by external economic drivers. Our ability to achieve both PCLs are also affected by other influencing factors, such as the role of government intervention.

22. The fact that Ofwat note that PCC is a "*well-established and understood measure of performance*" does not mitigate these inherent performance risks.

[3] See Appendix SES024 – ODI Design & Calibration to our October 2024 business plan submission, in particular Section C.

23. As we have set out in Appendix SES102, we consider:
    - On **PCC**, Ofwat's proposed PCL is set based on 'normal year' data only – which creates an achievability risk in the context of dry years occurring in the future. Also, no allowance is also made for the non-delivery of Government initiatives.
    - On **Business Demand**, Ofwat's proposed PCL is set at a stretching level beyond what is assumed in our WRMP. We are also concerned that the proposed mechanism designed to protect companies from uncontrollable changes in demand is not appropriately calibrated.
24. Overall, these factors, contribute to our assessment that the degree of risk actually reflected in the PR24 package is likely to be greater than Ofwat has assessed it to be in its draft determinations.

What Ofwat assumes 'base buys' adds an additional efficiency stretch

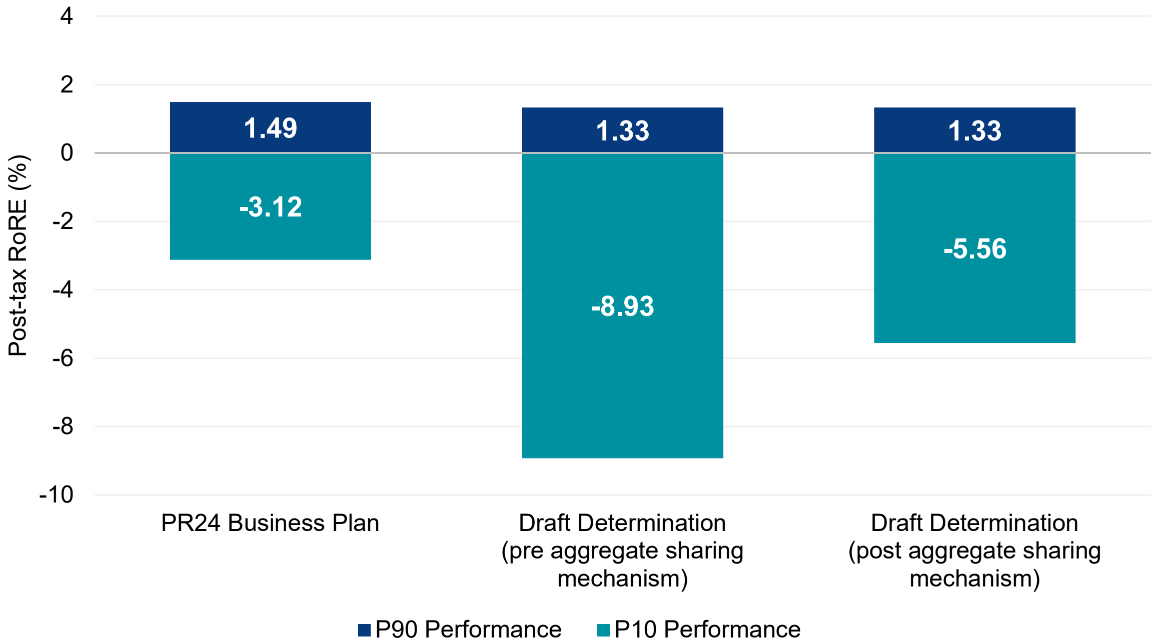
25. While we are generally committed to achieving the stretching PCs that Ofwat has proposed in its draft determinations, in several cases Ofwat has proposed that more of the requisite investment to deliver such improvements should be funded from base expenditure than in our PR24 Business Plan. This is on top of Ofwat accepting areas where we are already proposing to do more from base expenditure, and on top of Ofwat not providing a base cost allowance commensurate with our upper quartile performance.
26. For example, Ofwat has challenged us to fund a greater proportion of our proposed resilience schemes as base, along with elements of our IT enhancement spend. Many of these enhancement schemes would deliver outputs that go beyond what has been delivered by the sector so far. For example:
    - Our smart water production sites scheme proposed to further roll out our smart technology to our water treatment works, following the successful rollout of the technology to our network;[4] and
    - Our proposed project to develop an open data set that covers both the data from our smart network and the data provided from customer smart meters, would have been the first dataset of its kind within the sector.[5]
27. This implicitly contributes to the performance stretch embedded within Ofwat's current outcomes and cost proposals when considered in the round.

Overall assessment of impact on RoRE of Ofwat's draft determination proposals on outcomes

28. To appraise the impact of Ofwat's draft determinations on ODI rates and PCLs on our risk exposure, we have replicated the RoRE analysis we undertook for our business plan submission. This is set out in further detail in Appendix SES102.
29. We calculate the financial penalties associated with identical assessed P10 and P90 performance levels in our business plan, except using Ofwat's draft determination PCLs, ODI rates, and caps and collars. The outcome of this analysis is summarised in Figure 2 below.

[4] SES Water (2024) Appendix SES007 Enhancement Case: Enhancing the Resilience of Our Water Treatment Works and Processes
[5] SES Water (2024) Appendix SES000 Enhancement Case: Smart Water Customer Experience

Figure 2: Outcomes RoRE based on the PCLs and ODIs assumed in the PR24 business plan and what has been set in the draft determination



Source: SES Analysis
Note: We use P90 and P10 performance levels in our business plans across all three calculations.

30. Figure 3 shows that our ODI RoRE range has increased materially on the downside relative to what was assumed in our PR24 business plan. After the application of the aggregate sharing mechanism, P10 performance equates to a -5.56% RoRE impact while P90 performance equates to +1.33% RoRE impact.

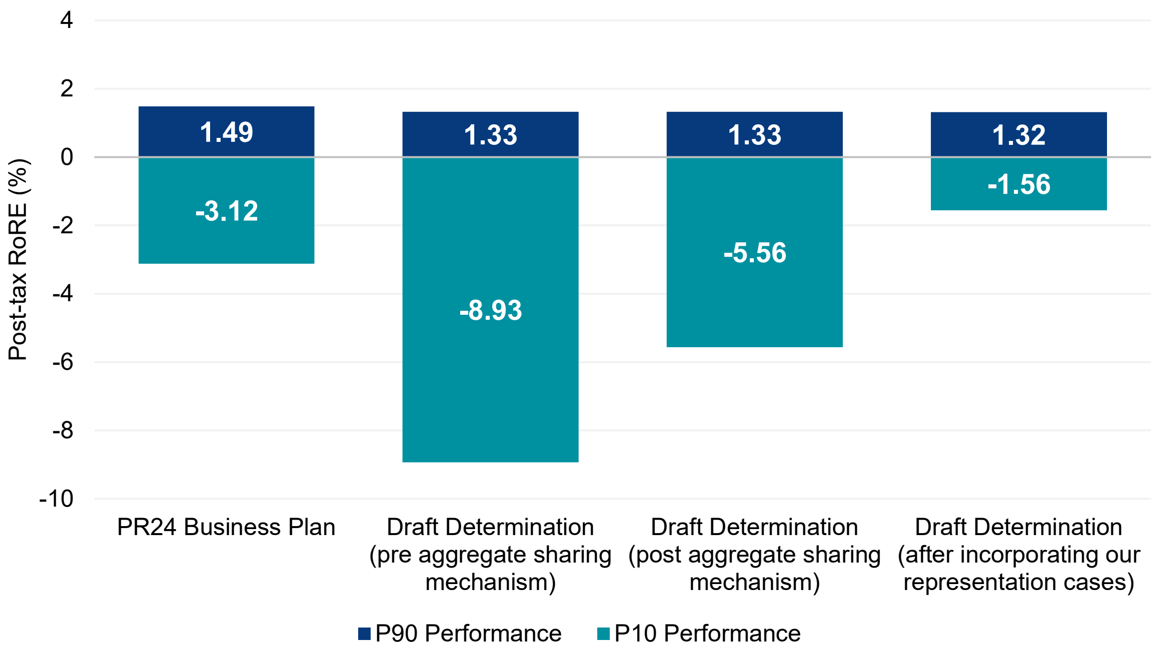
31. While the aggregate sharing mechanism for ODIs to help constrain the risk in the P10 case does not seem consistent with underlying design philosophy of Ofwat's introduction of this mechanism.

32. Prior to the application of this aggregated sharing mechanism our assessment of the P10 performance levels would imply a -8.93% RoRE reduction: a financial penalty that far exceeds Ofwat's base allowed equity return of 4.80% for PR24. This cannot be considered a balanced package of risk and return and as a consequence we conclude that a series of changes are needed in Ofwat's final determinations to bring the outcomes package back into balance.

33. Appendix SES102: Outcomes sets out four targeted representations which are necessary to achieve a better balance of risk and return at the final determination:
    - The ODI rate for Discharge Permit Compliance.
    - The PCL and ODI rate for Water Quality Contacts.
    - The PCL for Per Capita Consumption as well our proposal to introduce a new mechanism to protect companies against the non-delivery of Government initiatives.
    - The PCL for Business Demand as well our proposal to reform the draft determination end of period PCL adjustment mechanism.

34. The impact of these representation cases being adopted in the final determination is illustrated in Figure 3 below.

Figure 3: Comparison of ODI impact on RoRE based on the PCLs and ODIs assumed in the PR24 Business Plan, what has been set in the draft determination and what is proposed in SES Water's representation cases



Source: SES Water analysis

35. Figure 3 shows that our four representation cases create more symmetry in the balance of risk and reward across the package of ODIs. The ODI impact at the P10 performance level falls from -5.56% to -1.56% while the ODI impact at the P90 performance level falls marginally from +1.33% to +1.32%. These cases and their impacts are discussed in more detail in Appendix SES102: Outcomes.

C. Costs and price control deliverables

Wholesale costs

36. Ofwat's assessment of our wholesale cost risk ranges are broadly symmetric and reflect a P10 and P90 range of approximately 1% of regulated equity.[6] This is broadly consistent with the assumption reflected in our Business Plan submission.

37. Following our review of the draft determinations, we assess that there are several elements within the determinations that affect the risk of under/overspend. The net effect of these elements is to present a wider risk range than we assessed in our Business Plan, and also wider than is reflected in Ofwat's assessment of the draft determination risk ranges:

    (a) The inclusion of an uncertainty mechanism in relation to energy prices is a welcome proposal, which will serve to reduce risk. However, even with this intervention, some residual risk remains.

    (b) The strength of ambition across the sector on the rollout of smart metering, coupled with the strength of the Price Control Deliverable (PCD) connectivity and completeness thresholds for smart meters, serve to constrain the market. This means there is greater risk around the price of the smart meter rollout than originally envisaged in our Business Plan submission.

    (c) Our most material concern with wholesale costs is that the draft determinations have not provided the required allowed wholesale totex to support the outcomes / PC ambition that we have proposed in our Business Plan. This is the case for both base and enhancement allowances but particularly base where we consider Ofwat's draft determinations provide an insufficient allowance to run our core services.

38. On the uncertainty mechanism in relation to energy prices, we welcome Ofwat's proposal to introduce one though we also wish to highlight that this mechanism does not fully reduce our risk exposure. Ofwat's proposal introduces a new 'basis risk' into the price control that our contracted energy prices may not align well with the movement in the energy price index that Ofwat has proposed to use for the ex-post true-up mechanism. We also highlight in Appendix SES105: Energy Prices, that Ofwat has only partially protected our cost base from energy price movements which, if not corrected, would leave us still exposed to energy price risk.

39. The proposed large-scale rollout of smart meters across the sector means that there will be increased competition for access to the supply chain. This will likely shift market dynamics towards a 'supplier-led' environment rather than one driven by demand, heightening the risk of input price inflation—something the draft determinations do not adequately account for in its assessment of wholesale cost risk ranges. This issue is further aggravated by the PCD time incentives in the draft determinations, which limit our flexibility to adjust our plans in response to market price signals.

40. Furthermore, the connectivity and reporting thresholds that Ofwat proposes to use for determining whether a smart meter has been delivered for PCD purposes, creates significant uncertainty given limited sector experience of rolling out such smart meters. It is unlikely that suppliers will be willing to agree back-to-back arrangements without imposing significant cost premia. And so, we will either be forced to bear this additional cost or bear the PCD risk.

41. The wholesale cost allowances provided in in the draft determinations are not, in our view, consistent with a notional efficient company. Our P50 view, based on the totex allowances the determinations are that we do not expect to be able to earn our allowed

[6] See Figure 3 Ofwat (2024): 'PR24 draft determinations: Aligning risk and return appendix', p. 10.

return. Such a scenario would be in breach of a core regulatory principle that price controls should, on an ex-ante basis, provide for financial capital maintenance. The cost targets in the draft determination allowances do not, in our assessment, reflect those of an efficient company because:

- Ofwat has not fully accounted for the impacts that the topography of our water resources and water network has on our operating expenditure - in particular, power costs;
- The full additional and efficient expenditure that we require in the next AMP to support our statutory softening obligations has not been allowed; and
- The draft determinations include a series of unjustified cost challenges in its benchmarking of our required base and enhancement expenditure and have not adequately accounted for our ambition or specific circumstances.

42. As many of these cost challenges relate to base, they are not activities we can delay or vary as they relate to core operational requirements of our wholesale business. Ofwat's current assessment of SES Water's required expenditure in effect:

- Leads to a high likelihood that the expenditure allowances cannot be achieved on an expected basis without us risking the delivery of a basic level of service to our customers; and
- That our actual expected cost performance is skewed to the downside as result of overly stretching efficiency targets in Ofwat’s cost assessment.

43. Comparing the draft determination proposals and our view of required totex in AMP8, there is an increased likelihood of us overspending. So, the downside skew of our actual RoRE range has increased compared to our Business Plan submission. We have as result, revised our wholesale cost P10 / P90 cases from +/- 6% under/overspend to +12% overspend and -6% underspend in our assessment of the draft determination case. The +12% reflects the difference between our Business Plan totex proposal and the draft determination totex allowance, after accounting for cost sharing. In our representation case, that assumes Ofwat address the issues we have raised with its draft cost assessment, we revert back to a +/- 6% under/overspend range as per our Business Plan submission although note that the new basis risks around the energy true-up mechanism might suggest this is a conservative assumption compared to the true risk range.

Retail costs

44. Ofwat has assumed a RoRE range of -0.30% to +0.30% for retail costs in its draft determinations. In the supporting commentary it notes that while its determinations do not allow for automatic indexation of allowed retail costs to an inflation index, it has reflected expected input price pressure in the revenue allowance it has set.

45. Ofwat’s assessment is broadly consistent with our PR24 Business Plan although our assessment suggested a slightly negatively skewed distribution (0.27% upside and -0.41% downside) driven by the uncertainty and headwinds we face in our labour costs and other drivers of price inflation.

46. We continue to have concerns with Ofwat’s proposal to not index allowed retail costs to an inflation index but overall are content with the base allowances that Ofwat has proposed in its draft determinations. In the round, we are content with the range of risks we face ex-ante in this element of the PR24 package. In our updated modelling, we have assumed a P10/P90 range of +/- 6%, on the basis that the proposed retail allowance in Ofwat’s draft determinations broadly reflects our Business Plan view of costs.

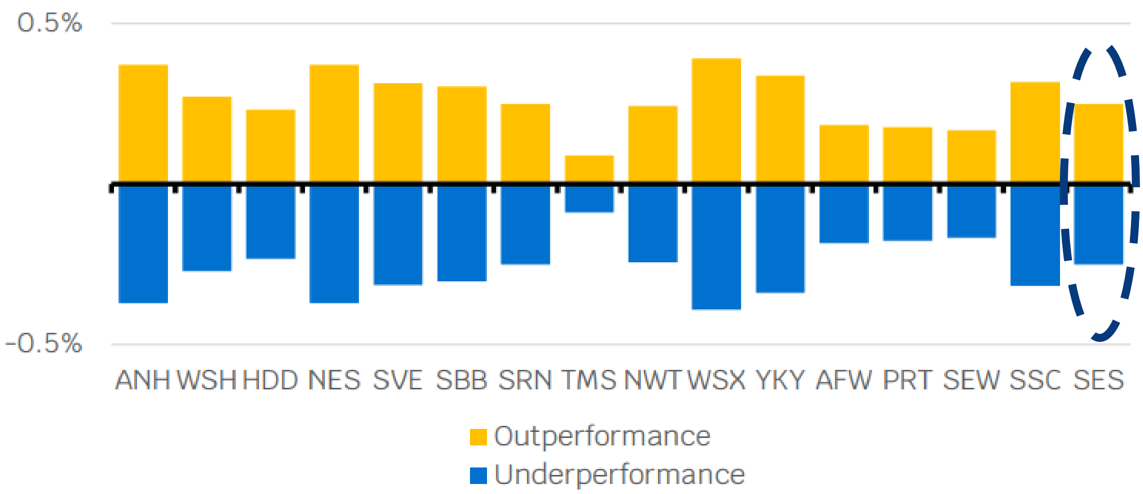
Price control deliverables

47. Ofwat has extended the use of PCDs in its draft determinations, a financial incentive intended to protect customers from partial or later delivery of enhancement projects.

48. Ofwat state that "[w]*e do not consider that returning funding to customers should be included in* [RoRE] *risk ranges. This seeks to ensure that customers do not pay for quality improvements that do not materialise. It recovers additional funding not returned under cost sharing, resulting in a company being no worse off. We consider the scenario that a company incurs significant abortive costs, that cannot be considered as design work for future improvements, should not be a material risk for an efficient company.*"[7]

49. However, Ofwat has included an assessment of the impact of the 'time incentives' that will apply with PCDs in its RoRE assessment - i.e., underperformance payments where companies deliver late and outperformance payments where companies deliver on time – as illustrated in the figure below.

Figure 4: Ofwat PR24 draft determination PCD risk ranges calculated as a percentage of appointee regulatory equity



Source: Ofwat

50. Ofwat's draft determinations propose the following PCDs for SES Water:
    - Metering
    - Mains renewals
    - Water softening
    - Water investigations
    - Raw water deterioration and taste, odour & colour
    - Security (SEMD)
    - Resilience uplift

51. This compares to a more targeted – and in many cases more powerful – set of PCDs compared to the proposals that we included in our original Business Plan submission (Annex A provides a brief comparison of Ofwat's PCD proposals compared to the proposals that we included in our Business Plan).

[7] Ofwat (2024): 'PR24 draft determinations: Aligning risk and return appendix', p. 11.

52. As illustrated in Figure 4 above, Ofwat in its draft determination assessment of risk ranges, seems to have concluded that the balance of risk and reward in PCDs to be broadly symmetric. There are a number of factors that mean we do not consider the risk ranges to be symmetric and indeed, they are downward skewed.

53. The design of the PCDs creates a:

- **Technology risk** – For the smart metering programme specifically, Ofwat is proposing a PCD mechanism that could claw back funding even if we have incurred expenditure to deliver our smart metering programme. Should the smart metering technology we use fail to deliver the reporting and connectivity standards set out by Ofwat, the PCD as currently designed will claw back the associated funding for the programme. This risk is largely one-sided, downward only.
- **Double counting risk** – In its final methodology guidance Ofwat stated that PCDs should provide additional protection not already provided by ODIs. There is still a risk that companies are double penalised for late delivery if this results in clawback and time incentive payments under PCDs in addition to ODI penalties.
- **PCD clawback greater than avoided cost risk** – Depending on how Ofwat sets the PCD penalty rate – for example, if it includes fixed costs within its rate calculations – there is a risk that PCDs, rather than a clawback mechanism for under delivery, prevents companies from recovering their incurred as well as avoided costs.[8]
- **A greater time penalty risk** – Under Ofwat's draft determination proposals, the time penalties for delay are greater than the rewards that we will receive if we manage to deliver certain investment to the timings expected. The table below shows the proposed time-related under- and out-performance PCD rates for the two enhancement items covered by such incentives.

Table 1: Proposed time incentives for SES Water PCDs in Ofwat draft determinations

Time incentives	Unit	Under-performance	Out-performance
Smart metering			
New installations	£/meter	14.13	3.53
Meter upgrades	£/meter	2.79	0.70
Meter replacements	£/meter	4.58	1.14
Mains replacement			
Base wholesale water model funded renewals	£/m	10.37	2.59

Source: Ofwat

54. How the PCDs will play out in practice has a significant degree of uncertainty because Ofwat has never used them to the same extent it proposes to in its PR24 draft determinations. There is also limited data to inform plausible modelling assumptions on how different scenarios across outcomes, costs and PCDs would be likely to play out in practice in the downside and upside cases.

55. We would expect a degree of correlation in how under- and out-performance scenarios would play out across the different elements of the PR24 package, in particular arising from our smart programme. This programme remains our highest value enhancement

[8] In effect, this would occur if penalty rates are based on average cost not the marginal cost that a water company avoids in the event of an investment programme delay.

claim, involving the greatest delivery and execution risk, but that also is critical to long-term ODI performance and has high-value PCDs around PCC, business demand, and leakage.

56. Given these uncertainties, we have adopted a simple scenario-based approach to reflect PCDs in our updated RORE risk ranges. In the:

- **P90 case** – we assume a 110% delivery upside scenario for mains renewals and 100% delivery for the metering programme. This provides additional incentive income, via the time incentive payments which add to the RORE upside in this performance case, and results in no clawback of additional expenditure.
- **P10 case** – we assume an 80% delivery downside scenario for mains renewals and 70% downside for the smart element of the metering programme. The results in a time incentive penalty and a PCD non-delivery (clawback payment). In this performance case, we also account for the avoided spend impact on RORE from the delay to the programme.[9]

57. We have not included PCD payments in our P10 cases for a number of other areas of PCDs proposed by Ofwat. This includes the softening PCD for which we consider there is a very high likelihood of it being delivered.

58. This modelling results in:

- For the **metering PCD,** a RORE risk range of -0.28% in the P10 case and +0.06% in the P90 case, averaged across the AMP.
- For the **mains renewals PCD,** a RORE risk range of -0.02% in the P10 case and +0.03% in the P90 case, again averaged across the AMP.

[9] This means that the PCD penalty is not the full payment rate, as it is offset by a reduction in spend.

D. Finance costs

59. Ofwat include the risks associated with inflation and the cost of new debt within its finance risk ranges. Overall, Ofwat concludes that for these items:

> The finance reasonable range of the impact on equity for an efficient company with the notional financial structure, before considering the impact of tax, is -0.61% to 1.20%. We assume that companies will continue to be subject to 25% corporation tax and thus a loss will reduce the tax bill and a gain will increase the tax bill (over the long term). After taking this into account the reasonable range of the risk to equity is between - 0.5% and +0.9%.[10]

60. Our assessment in our original PR24 Business Plan, under a notional capital structure, was instead that the aggregate range for these finance items was 0.67% on the upside (P90) and 0.70% on the downside (P10). In part our assessment of the downward skew in the risk range was driven by our expectation that as a small, and relatively infrequent water company issuer, the risk of us out or underperforming Ofwat's new cost of debt allowance was greater than the indicative RoRE range of 0.7% (outperformance) to 0.3% (underperformance) assessed by Ofwat in its final methodology.

61. We continue to conclude that Ofwat's assessment of these parameters remains overly upside weighted. We also continue to believe that our Business Plan assumption, of a largely symmetric risk range of +/- 0.7% for inflation and new debt impacts, remains a more appropriate assumption.

62. Further, Ofwat has continued to adopt the principle that the risk that the cost of embedded debt differs from the central estimate that will be reflected in its own modelling of the notional company's balance sheet as of 31 March 2025, should not be reflected within the RoRE financing risk ranges.

63. As we set out in our original Business Plan submission, we disagree with this view, as given the specific circumstances associated with the embedded cost of debt that we will in practice face during the next AMP, it will have a material impact on the expected balance of risk and reward from the delivery of our plan.[11]

64. In practice, we expect to under-perform in relation to Ofwat's embedded debt allowance given our legacy index-linked debt will only start to be repaid in the second half of the forthcoming AMP. While the precise impact on RoRE in AMP8 is difficult to estimate given the complexity of the financing plan, the impact could potentially be material.[12]

65. This further contributes to our view that our actual risk range on an expected basis for us is not symmetric, and in practice the business faces a higher likelihood that it will not be able to earns its expected return once a range of factors, including Ofwat's assumptions on embedded debt, are taking into consideration. This further contributes to a view that the draft determinations are downward skewed.

[10] Ofwat (2024): 'PR24 draft determinations: Aligning risk and return appendix', p. 21.
[11] As we previously demonstrated in our PR19 Business Plan submissions, this was efficiently raised debt consistent with prevailing market rates at the time of issuance.
[12] Our Business Plan estimated the impact could be 0.4- 0.9% RoRE p.a. in AMP8 taking into consideration differences in bond values and indexation charges between RPI and CPIH.

E. Summary of our view on RoRE risk ranges

66. Overall, as we have set out above, we consider that the balance of risk and return in Ofwat's current proposals for PR24 is downward skewed. In particular:

- Ofwat's own assessment of RORE shows we face one of the most heavily downward skewed positions amongst companies in the sector.
- This is before a range of factors we have listed above contribute to further downward risk for the actual company than is reflected in Ofwat's assessment.

67. Our revised central case – assuming Ofwat's notional capital structure – is that we would *expect* to earn a return of 2.85% in the forthcoming AMP. This is not a position that we consider consistent with a balanced package of risk and reward.

68. Table 2 below provides our overall assessment of the balance of risk and reward in Ofwat's proposed PR24 package and a summary of the key concerns raised in our representations elsewhere within our response to Ofwat's draft determinations. The areas highlighted green reflect where there is an appropriate balance between risk and reward, whereas the amber and red areas reflect where the balance is negatively skewed.

69. Note that the overall range for outcomes is post the impact of the ODI aggregate sharing mechanism while the average P10/P90 RoRE % values and prior to the impact of aggregate sharing mechanism (see Appendix SES102 – Outcomes representation for further details).

Table 2: Summary assessment of balance of risk and reward in Ofwat's draft determination PR24 package

Key items	Summary assessment	RAG assessment	P10/P90 assessment (Av. RoRE %)
Outcomes			**-5.56% / 1.33%**
Discharge permit compliance	Ofwat has set a disproportionate ODI rate for discharge permit compliance for WOCs, and SES Water in particular, given the small number of site permits that we maintain.		-6.29% / 0.00%
Customer water quality contacts	The PCL is set at the same level as PR14 and PR19 which is beyond the operational reality of what we can deliver. The ODI rate is also set at an extremely high level.		-1.12% / 0.31%
Per Capita Consumption	The PCL is set based on 'normal year' data only – which creates risk in the context of dry years occurring in the future. No allowance is made for the non-delivery of government initiatives.		-0.44% / -0.05%
Business demand	PCL is set at a stretching level beyond what is assumed in the WRMP. We are also concerned that a mechanism which is designed to protect companies from uncontrollable changes in demand is not appropriately calibrated.		-0.20% / -0.03%
Leakage	PCL set at the level proposed in our BP. But there are headwinds in achieving the stretching performance improvement given our		-0.37% / 0.27%

	UQ level industry performance. Some risk mitigated by decline in ODI rate.		
Mains repair	The PCL is set equal to what we said we would deliver but the ODI rate has fallen. Concerns relate to a link between Mains Repairs and Leakage – more leaks being identified mean more Mains Repairs occur.		-0.19% / 0.18%
GHG	The PCL will be challenging to deliver. But it is set at a similar level to what our BP proposed.		-0.06% / 0.00%
SPI	The PCL is set at the level of performance that we said we would deliver in our BP. The ODI rate has reduced.		-0.14% / 0.00%
CRI	The PCL is set at the level of performance that we said we would deliver in our BP. The ODI rate has reduced.		-0.11% / 0.00%
Biodiversity	The PCL stretch is consistent or below the level proposed in our business plan submission.		-0.01% / 0.10%
WSI	The PCL stretch is consistent or below the level proposed in our business plan submission.		-0.07% / 0.13%
U/P outages	The PCL stretch is consistent or below the level proposed in our business plan submission.		0.06% / 0.43%
Costs			**-2.36% / 1.22%**
Wholesale costs	Ofwat's wholesale cost assessment is not consistent with targets that reflect efficient notional company costs. Our revised company business plan view is that Ofwat's draft determinations would result in an expectation of overspend and a downward skew to RoRE risk ranges.		-1.86% / 0.93%
PCDs	Ofwat's proposals on PCDs add additional downward skew to the RORE package given the current design of these new incentive mechanisms and the interaction that delay to the programmes which have PCDs associated with them would have elsewhere in the PR24 package.		-0.30% / 0.09%
Retail costs	We have updated our RoRE assessment to reflect our assessment that there is less risk of under/overspend given Ofwat's proposals on retail costs.		-0.20% - 0.20%
Finance costs			**-0.70% - 0.67%**[13]
New debt	Ofwat's assessment of the risk is not significantly out of line with our own assessment as set out in our original business plan submission.		-0.09% - 0.06%

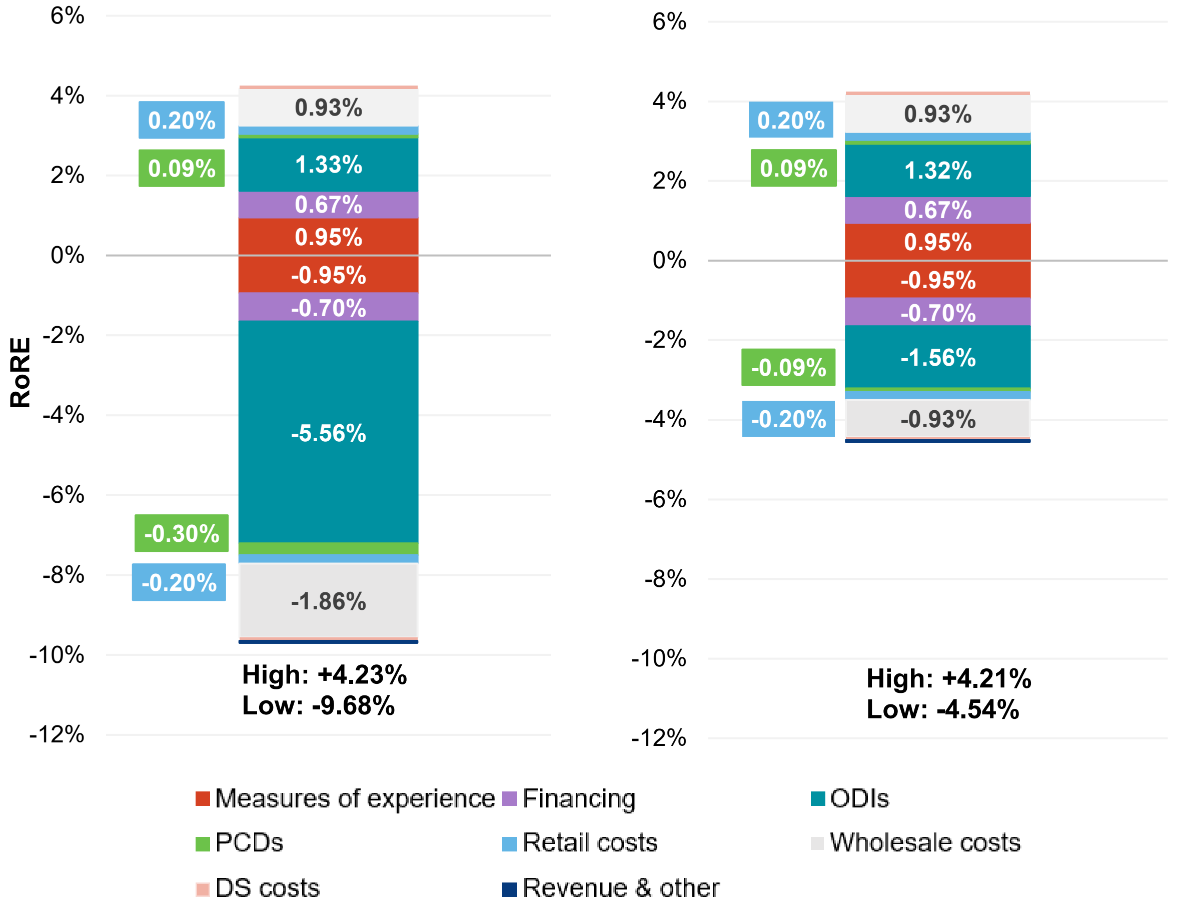
[13] Notional financing structure.

Inflation	Ofwat's assessment of the risk is not significantly out of line with our own assessment as set out in our original business plan submission.		-0.61% - 0.61%
Embedded debt	For the reasons set out above, we consider actual embedded costs contribute to an expectation that the actual RoRE risk for the company is downward skewed.		-0.4 to -0.9% p.a.[14]

Updated RORE risk ranges if our draft determination representations are adopted

70. While we have major concerns with the balance of risk and return in Ofwat's draft determinations, there are a series of targeted changes that will bring the PR24 package back into balance. These are justified in a series of separate representations that accompany our draft determinations response. Figure 5 below shows our updated assessment of the actual PR24 RoRE risk ranges once these interventions are applied to Ofwat's draft determination.

Figure 5: SES Water assessment of PR24 RoRE risk ranges (P10/P90) for Ofwat's DD proposals (left) and after applying SES Water's representation cases (right)



Source: SES Water analysis

[14] See Appendix SES069 – RoRE ranges in our Business Plan submission (para., 20) for discussion of this indicative figure.

71. It can be seen from the figures that our representations seek to rebalance our exposure to risk and potential for reward, relative to the Ofwat draft determination proposals.

Annex A. Comparison of SES business plan and Ofwat draft determination PCDs

Price Control Deliverables		
SES Water business plan proposals for PCDs		
PCD areas	**Deliverables and non-delivery payment rate**	
Smart meter programme	AMI meter installations: £47 per meter + £3.40 per year per meter for comms Deliverables for fixed element to be specified Total exposure of £18.5m of the £22.3m totex over AMP8	
Schools lead reduction programme	Number of schools per year with a unit cost of £20k Full exposure (totex of £3.4m over AMP8)	
Enhanced water treatment and network resilience programme	Four resilience schemes Full exposure (totex of £4m over AMP8)	
Ofwat draft determination proposals for PCDs		
PCD areas	**Unit**	**Non-delivery payment rate**
Metering	£/meter	New installations: 386.17 Meter upgrades: 76.19 Meter replacements: 125.02 (+ time incentives)
Mains renewals	£/m	283.24 (+ time incentives)
Water softening	£ per mg/l deviation	18,294.77
Water investigations	£m/WINEP action	0.257 - 0.435 depending on scheme
Raw water deterioration and taste, odour & colour	£m per unit	2.065
Security (SEMD)	£m/DWI legal instrument	0.321
Resilience uplift (climate change)	-	To be decided at final determinations