APPENDIX SES117

SUMMARY OF OUR DRAFT DETERMINATION RESPONSE

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1. In October 2023, we submitted our Business Plan for 2025 to 2030 to Ofwat. We set out an ambitious programme of activity to deliver improved outcomes for customers, the environment and wider society costing £413.9m over the five-year period. Since then, our performance has broadly matched our assumptions, which means we are following our plan trajectory.
2. We welcome Ofwat's recognition of our plan's quality and ambition, and the incentive that accrues as part of that assessment. Through that lens, we are representing on four key areas summarised below, which will enable us to deliver our plan efficiently and effectively.
3. In its draft determination of our Business Plan, Ofwat reduced our total expenditure allowance to £324.1m. This creates a £89.8m shortfall in the costs needed to run our core wholesale business, achieve higher performance standards and meet new legal and regulatory requirements.
4. In our response to Ofwat's draft determination we maintain that £413.9m is an efficient and appropriate spending allowance over the 2025 to 2030 period. A significant proportion of the shortfall can be made up by the inclusion of £46.2m of cost adjustments for our unique water softening and pumping requirements.
5. We have updated our financial modelling with customer bills now forecast to rise by 10.6% by 2029/30 compared to 2024/25, at an average bill of £247.32.
6. We have some significant concerns associated with the draft determination and we provide more information and evidence to Ofwat to support its final determination decision on our Business Plan in document SES101: Business Plan 2025 to 2030 Draft determination representation and supporting appendices.

Outcomes and incentives

7. We maintain our position that the package of performance commitment levels (PCL) and ODIs in our PR24 plan will deliver stretching performance and reflect our customers' priorities. The performance levels we will deliver in AMP8 follow a trajectory that will enable us to achieve our long-term ambitions set out in our LTDS. We make representations where targeted changes to the ODI rates and PCLs are needed to put our overall outcomes package back in balance.
8. The ODI rate for Discharge Permit Compliance results in a significant downside skew. We require Ofwat to recalculate the ODI rate, so it mirrors a more normalised approach across the industry – reflecting a post-tax RoRE in the region of 0.03% to 0.15% per site failure for all WoCs.
9. Likewise, the PCL and ODI rate for Water Quality Contacts result in a further downside skew. We request that Ofwat changes the PCL for water quality contacts at 0.58 contacts per 1,000 customers and adjusts the ODI rate to £0.812m.
10. Furthermore, the PCL for Per Capita Consumption (PCC) and Business Demand should be returned to the levels included in our PR24 Business Plan, so they are realigned with our Water Resources Management Plan (WRMP). We consider Ofwat should introduce an uncertainty mechanism around delivery of government policy interventions as the PCC target proposed is dependent on their implementation.
11. In addition, we consider the PCDs proposed for water softening and smart metering need to be recalculated in both cases to ensure efficient delivery.

Base cost allowance

12. We have significant concerns with the allowed expenditure in the draft determination and conclude that a significant increase in funding is required at final determination. We have identified a series of representations on how we consider Ofwat's base cost modelling needs to change at final determination to provide us with an adequate and efficient level of allowed totex that reflects our unique circumstances and the level of outcomes performance we will deliver from base in AMP8.

13. We have presented two revised cost adjustment claims of £46.2m. The first relates to the topography of our operating area and the impact this has on the relative volume of power consumption and pumping costs within our business relative to others in the sector. The second relates to the additional costs we incur relative to others in the sector associated with softening the water that we provide to our customers, which is a unique, statutory requirement.
14. We have identified issues with the way in which energy cost (price) adjustments (EPA) have been calculated by Ofwat in its base allowances. We have calculated the impact that our representations on Ofwat's energy price adjustment and the true-up mechanism would have on our base cost allowance and estimate this provides an additional £23m of allowed totex.
15. We have assumed the additional funding we consider is required from Ofwat's base modelling (to bring our overall base allowance into alignment with the efficient expenditure we forecast in our plan) will be provided by Ofwat in its final decisions and updates to its wholesale base cost modelling. We identify several factors that we request Ofwat considers in finalising its base cost modelling which are in part interrelated with the energy price and pumping adjustments referenced above, and also the performance ambition that we are expected to achieve from base spend.

Enhancement expenditure

16. Our PR24 plan included £53.4m of wholesale enhancement expenditure which was reduced to £38.6m in the draft determination. We have reviewed Ofwat's cost assessment and benchmarking approach, considered up-to-date information from the market and included some new requirements. Our updated view of the enhancement expenditure we require is £57.2m.
17. This includes £13m for leakage, which includes an extra £2.5m for the acceleration of fitting flow meters to all trunk mains – a new regulatory requirement, and £24.8m for smart metering. Our smart metering claim is £1.4m more than our original PR24 plan due to an underestimate in our original submission and follows significant engagement with the market on delivery costs. Both claims are critical to delivering the ambitious leakage and consumption reduction targets, aligned with our WRMP. We also make representations for lead replacement and resilience.

Risk and return and financing our plan

18. Ofwat's draft determination proposal of a low RCV run-off rate and a PAYG rate without infrastructure renewals expenditure, would temporarily reduce bills in the shorter term at the expense of higher bills for future customers – violating the intergenerational fairness principle.
19. We have reviewed our position and provided evidence for our higher RCV run-off rate. We maintain that the 7% RCV run-off rate is consistent with the natural rate when considering both historic and forecast levels of spend on capital maintenance and renewals and considering our proposed PAYG rate, which unlike other companies does not include renewals expenditure. We note that funding infrastructure renewals expenditure through PAYG and reducing the RCV run-off rate accordingly would provide similar results.
20. We have reviewed the overall package of incentives, cost allowances and uncertainty mechanisms contained within Ofwat's draft determinations and concluded that it presents a significant imbalance between the level of risk we are exposed to and our potential for reward, with a +4.2% to -9.7% RoRE range. Our main concern is the significant negative skew between risk and reward, primarily driven by the penalty rates for discharge consent compliance and water quality contacts proposed within Ofwat's ODI package. If the four representation cases on PCLs and ODIs are not successful, the downside impact of delivering performance commitment outcomes at the P10 performance level would alone be -5.56% RoRE.
21. We are also concerned that Ofwat's draft determinations, even in a central case, would not allow us to be able to earn our allowed return due to the unrealistic wholesale cost allowance.
22. We are financeable on an actual and notional basis after incorporating our responses to the draft determination, including our representations on totex, PAYG levels and RCV run-off rates, together with Ofwat's views on allowed returns, retail margins and official forecasts of inflation. This financeability is also predicated on the additional operational equity from 2024/25 and into AMP8 (modelled at £35m) from our parent company, together with £10m of de-gearing equity in 2024/25.