Our business plan 2020 to 2025

Re-submission to Ofwat on 1 April 2019

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Executive summary

Our Business Plan for 2020 to 2025 was submitted in September 2018. It was developed in partnership with our customers and committed to the delivery of stretching improvements to our service at an affordable price in the areas that matter most to them. Highlights of our September 2018 Business Plan include:

- An average bill of £207 per year
- £126 million investment to improve services – more than £400 per household
- A 15% reduction in leakage by 2025 to move us towards our target to halve leakage by 2045
- Helping customers to use less water by cutting consumption by 7.3% by 2025 and metering 90% of homes in our area
- Doubling the number of people who receive financial support to pay their bills
- Ensuring the right help is available for our customers in a range of vulnerable circumstances
- Reducing the chance customers will lose their water supply by investing in the resilience of our network and sources
- Enhancing the environment we rely upon by improving rivers, cutting carbon emissions and increasing the biodiversity of our sites
- Reducing our level of gearing to further increase our financial resilience
- An ongoing commitment to greater transparency of how we are owned, run and financed.

In our September 2018 submission, the total cost of our plan was £286 million, which included making £21 million of efficiency savings between 2020 and 2025.

Our plan, which was fully assured and owned by our Board, received strong support from customers and key stakeholders. Our level of ambition was recently endorsed by the Blueprint for Water coalition whose environmental scorecard placed our plan as a ‘standout’ performer.

The plan was developed through a comprehensive, high-quality customer engagement programme, proportionate to the relative size of our company, which was subject to ongoing challenge by our independent Customer Scrutiny Panel (CSP). Details of this can be found in the Engaging with our customers chapter of our September 2018 submission. The CSP confirmed that we engaged effectively with customers, that our plan reflected their priorities and we took good account of CSP feedback.

Following submission of our September 2018 Business Plan we demonstrated our commitment to greater transparency and Ofwat’s focus on enhancing trust and confidence through the publication of ‘Keeping it clear – a guide to how we are owned, run and financed’, which we will update on an annual basis.

Ofwat’s Initial Assessment of our plan

Ofwat carried out its Initial Assessment of our plan against nine test areas, identifying a number of specific actions which we have addressed in this resubmission.

Our priority as we reviewed Ofwat's comments and prepared our resubmission was to remain true to what our customers told us, so that between 2020 and 2025 we can deliver more of what matters to them.

As a result, there are areas where, having carried out further work, we have accepted Ofwat's feedback because it will result in better outcomes for our customers. In others we believe what we proposed is right and in this re-submission we have presented more evidence to support our position and decision making.

The performance commitments proposed have been subject to expert third party review by Frontier Economics who confirmed their stretching nature and that the associated Outcome Delivery Incentives (ODIs) reflect customer priorities and valuations. Where required changes to rates have been made.

Our CSP has continued to scrutinise our approach in preparing this resubmission and has provided an independent report summarising its views. We have worked closely with the CSP in the time available to give them early sight of key decisions made by the Board, most specifically on performance commitment changes and the reasoning for not further testing ODIs or long-term bill profiles with customers.

Our response to each of Ofwat's actions are addressed in detail against the relevant Ofwat test areas, details of which are set out below.

Key changes to our plan

The enhancements we have made to our plan as a result of Ofwat's feedback include:

- Providing more support to vulnerable customers by including a new performance commitment to increase the reach of our Priority Services Register and increasing the stretch of our target associated with awareness of our vulnerability schemes
- Removing three of our performance commitments to avoid duplication of measures whilst continuing to ensure we prioritise the areas that matter most to customers
- Making changes to the ODIs associated with our performance commitments on outages, water quality compliance, usage, void properties and first contact resolution
- Introducing an overall cap and collar on our package of ODIs of +/- 3% of RoRE to protect customers from significant outperformance
- Demonstrating a clear line of sight between our performance commitments and increasing the resilience of our operations
- Committing to embed a fully integrated, systems-based approach to resilience across our business
- Demonstrating our ongoing commitment to collaboration with industry colleagues to address shared challenges and drive innovation
- Providing evidence of our financeability against Ofwat's notional structure in addition to our actual structure – although the latter provides a more stringent test of financial resilience to 2030
- Removal of the uncertainty mechanisms for lead and business rates
- Providing further detail on how we will signal changes to our dividend policy and a commitment to enhance our executive pay policy so it is linked to strong service delivery

- Providing a set of fully compliant Board assurance statements for all Ofwat's assurance requirements.

Provision of further evidence

The areas where we have chosen to maintain our position and provide additional evidence to support our original submission include:

- Maintaining the ODI rates associated with many of our performance commitments following review by an independent third party who confirmed they were calculated appropriately and reflect customer preferences and valuations
- Demonstrating that we have included stretching performance commitments for areas including risk of supply failure, first contact resolution, customer concerns about their water and supporting customers in financial hardship
- Providing evidence that the costs we propose are efficient and will deliver what customers want while maintaining an average bill of £207 across the five-year period, a £16 reduction in real terms
- Updating the cost adjustment claim to enable us to deliver our unique water softening responsibilities
- Submitting an additional cost adjustment claim for wholesale electricity usage due to our high average pumping head and also for mains replacement investment to deliver leakage reduction, both of which have been externally verified by Mott MacDonald
- Providing evidence for why the costs associated with reducing leakage by 15% should be viewed as an enhancement and not included in full within our base costs
- Reassessment of our RoRE ranges and explanation of why a slight downside skew is not inappropriate
- Continuing to apply a 25bps company-specific adjustment to the weighted average cost of capital (WACC) which reflects the additional cost of debt we incur because we are a small company, and providing additional evidence of customer support and benefit. In addition, our view that our costs are appropriate and efficient for our company circumstances (noted above), complement this company-specific adjustment.

Delivering more of what matters

In this resubmission we maintain our focus on delivering five pledges to our customers between 2020 and 2025.

These will now be supported by 22 performance commitments which reflect our customers' priorities and will deliver stretching performance – which we believe will set the standard for the industry in key areas such as interruptions to supply, mains bursts, water quality and leakage.

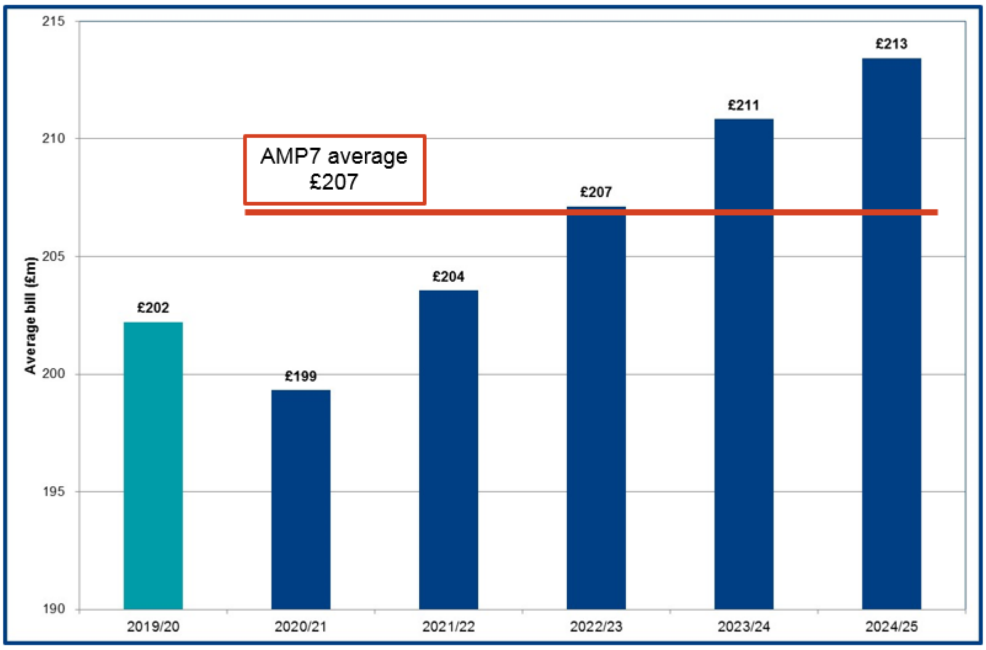
Of our performance commitments, 12 have financial penalties associated with them if we underperform, nine of which also have an outperformance incentive. In general, these are the commitments that customers have said they value most. Payments and/or penalties will flow through to customers' bills and this will happen 'in period' so performance in one year will impact on bills two years later. We have included an overall cap and collar on our package of ODIs so our customers are protected from significant outperformance.

We will report our progress against our performance commitments to customers regularly throughout the 2020 to 2025 period through a range of channels including our annual performance reports, on customer bills and through our website. Our Board and CSP will continue to monitor and challenge our performance to ensure we deliver the stretching targets we have set.

Affordable for all

In our September 2018 Business Plan submission, we proposed that the average bill for those who do not require financial assistance will be £207 per year. Following discussion with our CSP, we agreed to profile our bills so they rise steadily across the five years.

In this resubmission, the average bill remains at £207 between 2020 and 2025, this is a £16 reduction in real terms. We have maintained a smooth average bill increase.



Confidence and assurance

As in our original submission, the data, modelling and assumptions that have been used to build our plan have been independently assured by Mott MacDonald and EY. We recognise that the assurance provided by our Board in the original submission did not address all the areas required by Ofwat in its final methodology. To address this, and provide Ofwat and our customers with confidence of our Board's ownership of this plan, we have included an updated Board assurance statement to cover both our September 2018 Business Plan submission and this resubmission.

Navigating this document

In order to provide a clear line of sight between our original plan, Ofwat's feedback and this resubmission we have taken each of Ofwat's test areas and set out our response to each of the required and advised actions identified by Ofwat, highlighting clearly any changes to our plan. As a result, this resubmission document is organised into the following chapters:

1. Affordability and vulnerability
2. Outcomes for customers
3. Securing long-term resilience
4. Targeted controls, markets and innovation
5. Cost efficiency
6. Risk and return
7. Accounting for past delivery
8. Confidence and assurance

We did not receive any specific actions against the Engaging with customers test area, however where required, customer engagement is addressed within our resubmission.

Our CSP has been invited by Ofwat to submit a report alongside this resubmission on 1 April 2019 covering any aspects of the Business Plan resubmission that require assurance on the quality and influence of related customer engagement.

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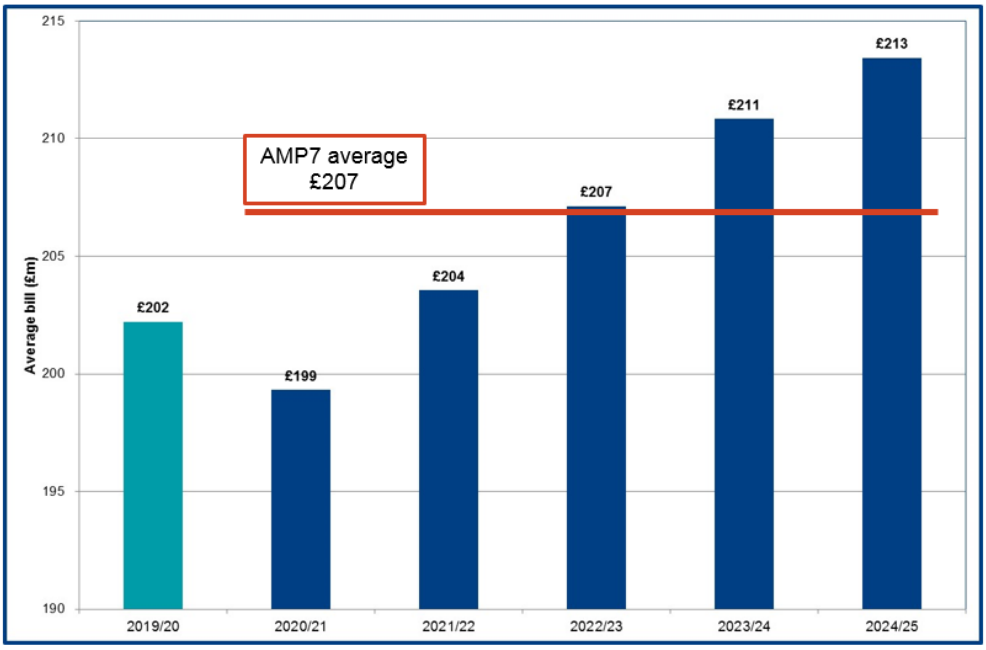
CHAPTER 1

Affordability and vulnerability

Addressing affordability and vulnerability

In our September 2018 Business Plan our proposed average bill (including inflation) was £207 per year. In its Initial Assessment of our plan (Test question summary assessment), Ofwat confirmed there was sufficient and convincing evidence that our plan will improve affordability overall from 2020 to 2025.

The average bill across the 2020 to 2025 period will remain at £207 in our resubmitted plan which is a £16 reduction in real terms. The slight change in average bill reduction is due to us now having greater certainty of 2019/20 prices. We will continue to phase the average increase across the period as shown in the graph below.



Between 2025 and 2030, our September 2018 submission proposed a further 6% decrease in bills and Ofwat recognises that there is sufficient and convincing evidence of a high-quality approach to assessing affordability of bills beyond 2025 and are satisfied with our use of financial levers.

One action was identified by Ofwat in relation to affordable bills, which was for us to undertake customer engagement on long-term bill profiles for the 2025 to 2030 period, provide sufficient evidence to demonstrate customer support for each of the profiles tested and have our approach assured by our Customer Scrutiny Panel (CSP). We have not been able to perform further customer engagement in this area, due to the limited time available to us to resubmit our plan, but we commit to ongoing engagement with our customers about affordability issues which we have discussed with our CSP.

Ofwat has also confirmed it proposes to introduce a new common performance commitment associated with increasing the number of customers on the Priority Services Register (PSR). We are supportive of this decision and had already included activity to increase the reach of our PSR in our September 2018 Business Plan. We have now formalised this as a performance commitment and set ourselves the stretching target of increasing our PSR reach to at least 7% by 2024/25 and commit to checking at least 90% of our PSR data every two years.

Included in the 'Delivering outcomes for customers' test area, were actions on a number of our performance commitments associated with our pledge to 'Provide fair prices and help when you need it'. In summary, our revised performance commitments for this pledge are as follows:

Fair prices and help when you need it			
Performance commitment	**We will**	**This means by 2025**	**Change to September plan**
Supporting customers in financial hardship	Increase the number of people who financially benefit from our re-designed social tariff	At least 19,000 customers will be on our water support scheme which provides a reduction on their bill	No change
Vulnerable support scheme awareness	Increase the awareness of our Helping Hand scheme and Priority Service Register with all customers	68% of our customers will be aware of the extra support we can offer to those who need it	Small change to definition to include minimum sample size Increase from 58% awareness by 2025
Vulnerable support scheme helpfulness	Ensure our Helping Hand Scheme and Priority Services Register is helpful to those that benefit from it and those that know about it	80% of customers asked will feel the extra services we offer are helpful	Small change to definition to include minimum sample size
Priority Services Register	Increase the number of people on our Priority Services Register	At least 7% of our customer base will be on our Priority Services Register and we will we check 90% of our PSR data every two years	New performance commitment
Void properties	Reduce the number of properties that are connected to our network but shown as vacant (void) so not billed	Void properties will account for no more than 2.2% of all properties in our supply area	No change

The performance commitments we included in our September 2018 submission to manage bad debt and deliver value for money have been removed from our revised plan following feedback from Ofwat.

Ensuring bills are affordable for all, including those in financial hardship, continues to be a priority. Our performance commitment is to have at least 19,000 customers on our Water Support Scheme by 2025, however, we won't stop once we achieve our target. Our shareholders have committed to funding the scheme if we exceed our target, as they have during this period, so all those that require financial assistance can access it.

Customer engagement on long-term bill profiles

SES.AV.A1: *SES Water has not provided sufficient evidence to demonstrate that it has tested multiple bills profiles beyond 2025 with customers. SES Water should undertake customer engagement on long-term bill profiles for the 2025-30 period and provide sufficient evidence to demonstrate customer support for each of the profiles tested. SES Water should confirm that testing has been assured by its CCG and conducted in line with social research best practice.*

We have not carried out further engagement with customers on long-term bill profiles for the 2025 to 2030 period as we are not deviating from the 'natural rate' for the PAYG ratio and RCV run-off rates and Ofwat accepted the position we reached. This means that bill profiles are also at the natural rate based on our mix of operational and capital expenditure to 2030. We will however, as part of our ongoing engagement with customers from 2020, seek their views on affordability and priorities as we deliver our plan.

The CSP supports our decision not to do further research given timescales. Ahead of our September 2018 Business Plan submission, the CSP reviewed two options on bill profiles and its feedback informed our final bill profile decision.

In our September 2018 Business Plan submission we provided details in the Engaging with customers chapter of how we will continue to engage with customers beyond the price review. This will be particularly important in the area of addressing affordability and vulnerability as insight from customers will be essential to help us improve the services we provide. Our intention is to have continuous dialogue with customers through our online community and on the ground as we increase our visibility in our local communities. We will be regularly monitoring customers' views on the help we provide through surveys, the results of which will inform our ongoing activity. Working with groups who represent and support our vulnerable customers will be critical and we will continue to nurture the relationships we have made through ongoing community outreach and co-creation of services that best meet the needs of those that use them.

Priority Services Register (PSR)

SES.AV.A2: *SES Water has not proposed a performance commitment on Priority Services Register (PSR) growth. It is proposing to increase its PSR reach from 1.5% in 2019/20 to 15% of customers in 2024/25. This is a sector leading target. In addition, the company has checked 100% of PSR data over the past two years. This is sector leading performance as well. We propose to introduce a Common Performance Commitment on the Priority Services Register (PSR): The company should include a Performance Commitment which involves* *increasing its PSR reach to at least 7% of its customer base (measured by households) by 2024/25 and committing to checking at least 90% of its PSR data every two years. For further information on the performance commitment definition, and reporting guidelines, please refer to 'Common performance commitment outline for the Priority Service Register ("PSR")', published on the initial assessment of plans webpage.*

In our September 2018 Business Plan submission we did not include a specific performance commitment on PSR growth but did state that we would increase our PSR reach from 1.5% of customers in 2019/20 to 15% by 2024/25. This was an industry leading target, as is 100% of the register data being checked over the last two years.

In response to Ofwat's action to introduce a common performance commitment to increase the reach of our PSR we have reviewed the data included in our original submission and revised our target accordingly, while ensuring it is stretching. Based on this, we have included a performance commitment to increase the reach of our PSR to at least 7% by 2024/25 and check at least 90% of PSR data every two years.

The target we have set is based on the number of households that will be on our PSR. The projection of performance improvement proposed in our September 2018 Business Plan was based on the number of customers on our PSR, therefore the change from 15% to 7% reflects the change from individual customer numbers to household numbers.

Since our September 2018 submission, we have also gained a better understanding of how a data sharing initiative between water and energy companies, which we are relying on to increase our PSR reach, will be implemented. This will not provide an immediate full data share of all PSR customers across all companies when the scheme goes live, rather we will receive gradual information about eligible customers that will be triggered upon new customers being entered or customer data being renewed. Therefore, the impact on our PSR reach will not be as great as we had originally anticipated and it will take more time for it to realise maximum benefits.

It is important to recognise that the PSR performance commitment sits alongside two others - we have proposed stretching targets to increase the number of customers who are aware of the help schemes we offer to vulnerable people and the helpfulness of the services we provide. Together, they demonstrate a strong commitment to provide the right support and assistance to our customers who are experiencing permanent and temporary difficulties. Furthermore we have committed to at least doubling the number of customers who receive financial support through our Water Support Scheme and our Board has committed to continuing to fund this if we exceed our target so all those that need extra help can access it.

In order to achieve our performance commitments, we will be focused in five strategic areas:

- Compliance
- Training
- Technology
- Communications
- Services.

Our plan is to focus on each of these areas to improve the richness of the service we offer to our customers whilst organically increasing awareness to our wider customer base. The figure below describes some of the initiatives and plans associated to each focus area.

Compliance:

- Change and update the Water Support Scheme renewal process
- Introduce a common south east water companies eligibility criteria for Water Support
- Implement a streamlined re-permission process for our PSR.

Training:

- Deliver identifying vulnerability training for all customer-facing employees
- Implement specialist and sensitive escalation training to specific teams and employees
- Work with external organisations on our training material and specialist courses.

Technology:

- Deliver the collaborative data share project 'P18002' with Water UK
- Offer end-to-end digital self-serve for key service journeys
- Introduce more appropriate and affordable contact methods such as text messages.

Communications:

- Tailored communications and correspondence for priority services customers
- Simplified, multi-channel PSR and Water Support Scheme application process
- Work in partnership with local organisations to promote our services
- Introduce behaviourally responsive customer communication.

Services

- Introduce single sign-up process for all our services
- Increased home visit and account management support
- Enhance incident support service and our advanced warning process for planned work.

CHAPTER 2

Outcomes for customers

Delivering outcomes for customers

Our September 2018 Business Plan was based on the most extensive programme of engagement to date to understand our customers' needs and priorities. The result was the development of 24 performance commitments, with associated Outcome Delivery Incentives (ODIs), which would enable us to achieve our five pledges and deliver great service to our customers.

Our plan was rooted in the views of our customers and stakeholders who want us to continue to deliver a high quality service at a price they consider fair. We have an excellent track record of delivering at a level that leads the industry in many areas and almost always meets the expectations of our customers. Where we are pushing ourselves to go further, it is in response to our customers' views and they have agreed that the small additional price to pay to do so is right for both them and future generations. In other areas, where we know we need to do better, we have plans in place and are committing to service improvements.

In its Initial Assessment of our Business Plan, Ofwat raised a number of actions associated with our package of performance commitments, the associated ODIs and how we will report on our performance. We address each of these actions in this resubmission, including introducing a new common performance commitment to increase the number of customers on our Priority Services Register (PSR) as mandated by Ofwat.

In preparing our resubmission, we engaged Frontier Economics to carry out an independent review of our ODIs – including conducting assurance on the calculation of the ODI rates; and to assess the implication of new evidence since the September 2018 submission through triangulation of our evidence with information from other companies' plans.

We have also provided more detail on how we intend to report on our performance to help increase the trust and confidence of our customers and stakeholders.

Performance commitments – definition and stretch

Of the 24 performance commitments proposed in our September 2018 Business Plan submission, Ofwat asked us to consider the definition and/or stretch associated with 12 of them to ensure that they will measure the right aspect of performance and that we will improve performance to an appropriate level over the five-year period. For our commitment to reduce customer supply interruptions, an area we had proposed industry-leading performance, we have scaled back our target in response to Ofwat's requirement to be in line with projected upper quartile performance.

For our two performance commitments associated with improving support to customers in vulnerable circumstances, we have included a minimum number of customers to be surveyed within the definition and we are proposing to set a more stretching target for vulnerable support scheme awareness. In addition, we have included a new performance commitment to increase the number of customers on our PSR.

In the case of our target for the Abstraction Incentive Mechanism (AIM), we have provided further detail on how we have adapted the AIM methodology and evidence of how we calculated the performance commitment target proposed. We will also provide a further submission in May to confirm the stretch associated with our performance commitment on unplanned outages of treatment works, which will take account of 2018/19 performance.

We have decided to remove three of our performance commitments in light of Ofwat's feedback. Managing bad debt will no longer be included due to lack of customer support. Customer confidence will not be included as a specific performance commitment due to the introduction of C-MeX, however we intend to continue to measure it as part of our ongoing customer insight programme. Perception of value for money is also no longer included, however we will continue to measure our performance through our own customer insight programme and through CCWater's annual survey and promote this to customers and stakeholders.

Ofwat considered our targets associated with customer concerns about their water; risk of supply failures; support for customers in financial hardship and first contact resolution as not being stretching enough. In each of these areas we have reviewed the target and consider each to be appropriate, providing an explanation for our decision.

The definition and stretch of the remaining 10 performance commitments will remain unchanged and we continue to await further guidance from Ofwat on the new C-MeX and D-MeX measures.

Outcome Delivery Incentives

The main challenge from Ofwat was on the ODI rates we had set for those performance commitments with an associated financial incentive. We were asked to provide further evidence that the marginal benefits estimates we used reflected customer preferences and valuations. We, like all companies, were also asked to provide further evidence for the forecast efficient marginal costs used in the calculation of ODI rates and to demonstrate how marginal cost estimates relate to cost adjustment claims or proposed enhancement expenditure. An independent review by Frontier Economics has confirmed that the estimates are reflective of the results of the high-quality willingness to pay research undertaken and, where applicable, additional evidence sourced from independent third-parties. In general it considered the approach taken to be sound, reasonable and in line with the Ofwat final methodology. Five ODI rates have been changed in light of the review for first contact resolution, unplanned outages, void properties, customer usage and water quality compliance. The results of this independent review are available in Appendix A.OC2.

Another area of challenge was on the type of ODIs that were proposed for our performance commitments. In our original submission, 11 of our performance commitments were subject to a financial ODI. Of these, seven were common performance commitments to be measured by all companies. Ofwat asked us to consider whether more of our performance commitments, particularly those that are bespoke to our customers, should have a financial incentive associated with them and to justify the decision taken. We have reviewed the type of incentive applied to all our performance commitments and sought a third party view from Frontier Economics. As a result, we have added an underperformance penalty to our performance commitment for unplanned outages at treatment works.

Ofwat require us to clarify which of our performance commitments will deliver improvements to our asset health and justify the underperformance and outperformance payments we propose, to ensure they are in the public interest. We have provided further quantification of the asset health metrics proposed but no material change has been made to this area.

We were also asked to put in place additional customer protection in the case of significant outperformance against our ODIs that could result in customer bill increases beyond levels customers had been willing to pay for. Ofwat asked us to consider the use of an appropriate sharing mechanism and review the caps on individual performance commitments. Evidence of how we will smooth bills to mitigate the impact of outperformance payments was also required. To address these points we are proposing an overall cap and collar to our package of ODIs.

Summary of our outcomes, performance commitments and ODIs

Later in this chapter we explain how we have responded to each individual action. The following summary table sets out our revised set of performance commitments, the 2025 target and the ODI associated with each.

High quality water all day, every day			
Performance commitment	**We will…**	**This means by 2025…**	**Outcome delivery incentive**
Supply interruptions	Maintain our high upper quartile position	We will reduce to an average of 3 minutes lost per customer per year	Underperformance penalty and outperformance payment
Mains bursts	Continue our strong performance in reducing the number of mains that burst	We will reduce to 57.8 bursts per 1,000km of water main	Underperformance penalty and outperformance payment
Customer concerns about their water	Maintain our industry leading performance of having the fewest contacts from customers about their water quality	We will receive no more than 0.5 contacts per 1,000 people about the taste, smell or appearance of their water	Underperformance penalty
Water quality compliance	Continue to produce amongst the highest quality water in the industry	We will keep water at industry leading levels, as measured by the DWI's Compliance Risk Index	Underperformance penalty
Fair prices and help when you need it			
Supporting customers in financial hardship	Increase the number of people who financially benefit from our re-designed social tariff	At least 19,000 customers will be on our Water Support Scheme which provides a reduction on their bill	Non-financial
Vulnerable	Increase the	68% of our customers will	Non-financial

support scheme awareness	awareness of our Helping Hand Scheme and Priority Services Register with all customers	be aware of the extra support we can offer to those who need it	
Vulnerable support scheme helpfulness	Ensure our Helping Hand Scheme and Priority Services Register are helpful to those that benefit from it and those that know about it	80% of customers asked will feel the extra services we offer are helpful	Non-financial
Priority Services Register	Increase the number of customers on our Priority Services Register	At least 7% of our customers will be on our Priority Services Register and we will we check 90% of our PSR data every two years	Non-financial
Void properties	Reduce the number of properties that are connected to our network but shown as vacant (void) so not billed	Void properties will account for no more than 2.2% of all properties in our supply area	Underperformance penalty and outperformance payment
A service that is fit now and for the future			
Risk of severe restrictions during a drought	Ensure that no customer is impacted by severe drought	Nobody we serve will be subjected to restrictions such as standpipes or water rationing during a one in 200-year drought	Non-financial
Risk of supply failures	Increase the connectivity of our infrastructure to ensure that every customer can be supplied by more than one source	100% of properties will be able to be supplied by more than one treatment works	Underperformance penalty and outperformance payment
Unplanned outages at treatment works	Reduce the likelihood of unplanned outages at our treatment works	An unplanned outage will only amount to 2.3% of our total peak week production capacity	Underperformance penalty
Leakage	Further reduce our already comparatively low level of leakage	We will reduce the amount of water that is lost each day by a further 15% from 24 Ml/day in 2019/20	Underperformance penalty and outperformance payment

Excellent service, whenever and however you need it			
Customer satisfaction (C-MeX)	We will improve our level of service so we have amongst the most satisfied customers in the country	We will be in the upper quartile of the industry league table	Underperformance penalty and outperformance payment
Developer Satisfaction (D-MeX)	Meet developers' needs on time and to a high quality	We will be in the upper quartile in the industry league table	Underperformance penalty and outperformance payment
First contact resolution	Reduce the number of times customers have to contact us about the same issue	85% of all customer contacts will be resolved first time	Underperformance penalty and outperformance payment
Supporting a thriving environment we can all rely upon			
Usage (per capita consumption)	Help customers reduce how much water they use	We will reduce the average amount of water used by each person by 7.3% from 145 litres per day in 2019/20	Underperformance penalty and outperformance payment
Greenhouse gas emissions	Generate and use renewable energy to limit the greenhouse gases we create from our operations	We will invest in and purchase renewable energy to limit our emissions to 55kg of CO_2 per million litres of water put into supply	Non-financial
Pollution incidents	Strive to never cause severe pollution to land, air or water	We will not cause any category one or two pollution incidents (as measured by the Environment Agency)	Non-financial
Abstracting water to treat (Abstraction Incentive Mechanism)	Reduce the amount of water we abstract from more environmentally sensitive water sources when river flows are low	We will limit abstraction from two chalk boreholes to an average of 7 Ml/day and a peak of 12Ml/day when groundwater is more than 43 metres below ground level	Non-financial
Improving land diversity	Strive to make the land we own more attractive to a variety of plant and animal life	We will achieve and maintain the Biodiversity Benchmark at three of our treatment works	Non-financial
Improving	Deliver the	We will have delivered 24	Non-financial

rivers through the delivery of WINEP	requirements of the Environment Agency's Water Industry National Environment Programme	river-based investigation and improvement programmes	

The table below summarises the incentive rates that will apply to the financial ODIs.

Performance commitment	**Underperformance penalty rate**	**Outperformance payment rate**
Supply interruptions	-£259,887 per minute	£241,233 per minute
Mains bursts	-£26,524 per burst per 1,000km	£15,592 per burst per 1,000km
Customer concerns about their water	-£796,186 per contact per 1,000 people	-
Water quality compliance	-£174,526 per unit of CRI	-
Void properties	-£248,221 per 1% of properties	£248,221 per 1% of properties
Risk of supply failures	-£72,516 per 1% of properties	£39,231 per 1% of properties
Unplanned outages at treatment works	-£72,680 per 1% of capacity	-
Leakage	-£745,400 per Ml/day	£717,639 per Ml/day
First contact resolution	-£3,261 per 1% of contacts	£1,631 per 1% of contacts
Customer satisfaction (C-MeX)	To be decided by Ofwat*	To be decided by Ofwat*
Developer satisfaction (D-MeX)	To be decided by Ofwat*	To be decided by Ofwat*
Usage (per capita consumption)	-£136,161 per litre/head/day	£147,699 per litre/head/day

*The C-MeX and D-MeX underperformance penalty or outperformance payment will be decided by Ofwat on an annual basis based on our score relative to other water companies. The maximum penalty and maximum payment for C-MeX are -/+ 2.4% of annual residential retail revenue. The maximum penalty and maximum payment for D-MeX are 5% and 2.5% of annual developer services revenue respectively.

Addressing Ofwat's company-wide actions

Performance reporting

SES.OC.A1: *The company should consider what performance reporting it will provide for customers beyond its annual performance report, including providing contextual information, to increase the impact of its ODI on reputation.*

Over the last year we have made significant strides in increasing the transparency of what we do and how we do it so all aspects of our operation are as clear as the water we produce.

This has included three key developments:

- An online, customer-friendly version of our annual report which focuses on our performance against our targets with customer case studies
- The publication of ‘Keeping it clear’, our first ever guide to how we are owned, run and financed which explains our finances and structure in an understandable way for customers and stakeholders. This is available at Appendix A.OC3
- Publishing summary Board minutes on our website.

Our customer bills have been completely re-designed which has provided the opportunity to review what performance information is included. Going forwards we will have sections dedicated to how we are investing our customers’ money and how this links to our performance against annual targets.

In terms of providing additional contextual information, we support the use of the Discover Water website and will look for more opportunities to promote its existence with our customers. This could include our website, annual report, email footers, bills, leaflets and social media advertising to target groups in our supply area. It’s also important that third party intermediaries such as our Customer Scrutiny Panel (CSP) understand what information the site provides and how often it is updated. From 2020 we will include industry comparative performance against the common performance commitments in our annual report.

We will also look to increase our local media and stakeholder activity around the release of key industry performance reports, such as Ofwat’s annual Service Delivery Report and CCWater’s Company Performance Report.

We will continue to discuss our performance and how we can increase the impact of our performance on our reputation with our ‘Talk on Water’ online customer community. This involves a group of over 200 customers taking part in regular discussions and polls to help us gather feedback and test new ideas. Recently we shared our half-year results with the group as well as our Keeping it Clear document and the Company Monitoring Framework documents and we will increase the amount of performance information we share with them.

The CSP will continue to input into the review and amendment of all customer facing information to ensure it remains appropriate for the audiences it is designed for.

ODI type

SES.OC.A2: *The company should provide further justification for setting the following PCs as non-financial; managing bad debt, perception of value for money, risk of severe restrictions in a drought, greenhouse gas emissions, pollution incidents, AIM, unplanned outages at treatment works and delivery of WINEP.*

We maintain our position that our pollution incidents performance commitment should remain non-financial. This is because a statutory process exists that penalises underperformance in this area, in the form of prosecutions and fines enforced by the Environment Agency. Therefore a penalty through an ODI would lead to us being financially penalised twice. We are the sole water only company to have included pollution incidents as a performance commitment and have done so in order to reflect the importance we place on our role in minimising the impact the water sector has on the environment.

For the risk of severe restrictions in a drought performance commitment we are targeting zero over the period, therefore an outperformance payment cannot be applied. We consider that a penalty only mechanism cannot be justified on this new measure as the triggering of drought-related restrictions such as water rationing and standpipes would have significant financial and reputational consequences for the company, so the incentive to avoid such measures is already high and a financial ODI would not provide any additional incentive.

Managing bad debt – please see SES.OC.A34

Perception of value for money – please see SES.OC.A36

Greenhouse gas emissions – please see SES.OC.A43

AIM – please see SES.OC.A46

Unplanned outages at treatment works – please see SES.OC.A23

Delivery of WINEP – please see SES.OC.A46

ODI rates

***SES.OC.A3:** The company should consider the ODI rates proposed and provide further evidence, either from its own customer base or wider industry studies, to demonstrate that the marginal benefit estimates used are reflective of its customers' preferences and valuations, or conduct further engagement to develop triangulated ODI rates that are based on a broader range of customer evidence. In cases of rejection or revisions to enhancement expenditure or a cost adjustment claim, the company should consider the implications, if any, for the associated level of the PC and ODI incentive rates proposed, and provide evidence to justify any changes to its business plan submission. In cases where a scheme will no longer be undertaken, the company should consider the removal of the associated scheme-specific PC. The company should provide further evidence to detail the estimation of forecast efficient marginal costs within its ODI rate calculations, in line with our Final Methodology. In particular, the company should provide evidence to demonstrate how these marginal cost estimates relate to the cost adjustment claims or enhancement expenditure proposed by the company.*

As part of its review, Frontier Economics considered the ODI rates proposed and how they were derived. Its report confirms that, where applicable, rates were derived from the marginal benefits evidence gained through our customer willingness to pay (WTP) research. Where other sources of evidence were used Frontier Economics confirms that the approaches taken were reasonable. The report is available at Appendix A.OC2.

Frontier Economics was also asked to evaluate our ODI rates in the context of the information now available for other companies' plans. We have revised five ODI rates as a result of this review and further information is included within our response to individual ODI actions below.

Further information on the marginal costs used in the calculation is provided in the amended Business Plan Data Tables. Marginal costs are derived from our totex requirements for delivery of our plan (as included in Table WS1 of the Business Plan Data Tables) and include both maintenance (base) costs and enhancement costs. It is necessary to include maintenance costs in the calculation of marginal cost because a reduction in maintenance activity will lead to a reduction in service levels. Our totex requirements, needed to deliver our plan that is supported by customers, were derived through bottom-up assessment of the expenditure required to deliver each activity, e.g. treatment works maintenance, mains replacement. Future efficiencies were included in our forecast of expenditure requirements.

Some areas of expenditure, such as mains replacement, have impacts on the delivery of multiple performance commitments. Where this is the case we have used our expert judgement in allocating costs to individual performance commitments. To set an annual marginal cost capex has been annualised (using appropriate asset lives) and added to opex.

For wholesale performance commitments (excluding usage) we have calculated marginal cost based on serving our population of household and business customers. Where required by the Business Plan Data Table guidance we have converted to represent household only based on the assumption that 84% of costs are recovered from households. This assumption is based on analysis of historical data on revenue recovered from the two customer groups.

ODI deadbands, caps and collars (SES.OC.A4)

This action is addressed through Customer Protection – action SES.OC.A9.

Enhanced ODIs (SES.OC.A5)

No company-wide actions were identified – individual performance commitment actions are addressed through our responses below.

Overall ODI package

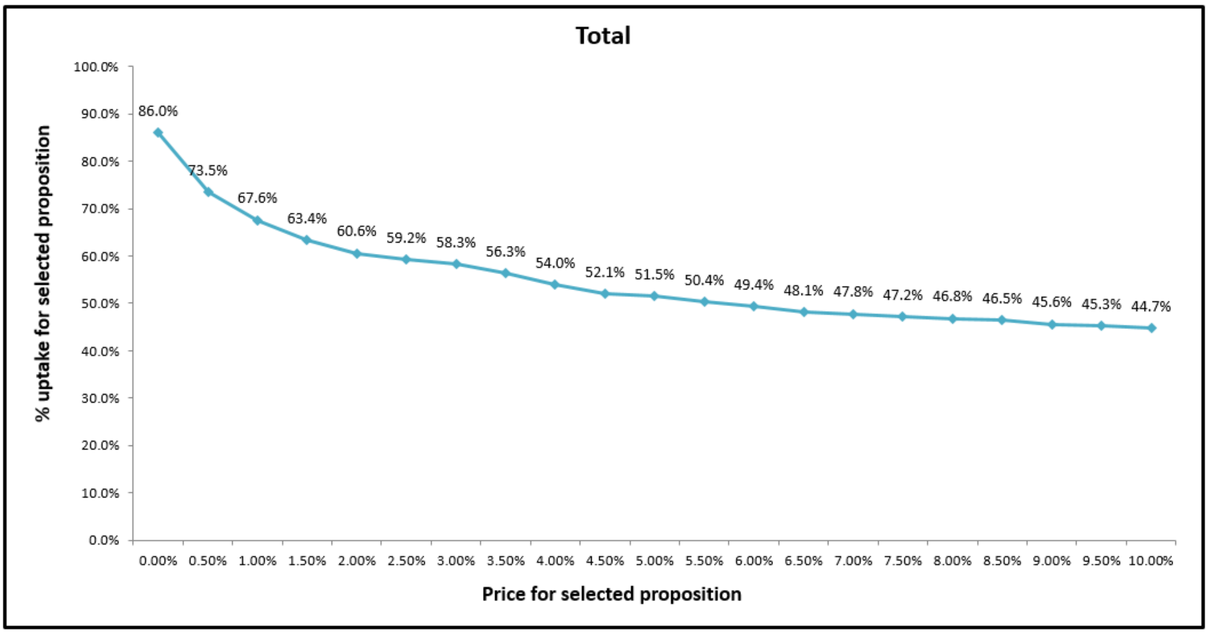
SES.OC.A6: *The company should provide further explanation of how its ODI package provides incentives through better aligning the interests of management and shareholders with customers, to deliver on its PCs to customers. The company should provide further evidence that the ODI package is supported by robust customer engagement and valuations. In particular, it needs to fully demonstrate how customer outcomes have been implemented and address concerns raised by the Customer Scrutiny Panel. The company should clarify how it has tested the acceptability of the ODI package with customers.*

Our performance commitments and associated ODI rates are driven by customer preferences and customer valuation of the benefits to them based on a survey where they were asked to evaluate a package of service changes and the resulting changes to their bill. Frontier Economics has provided its assessment of the survey approach taken and considers that it produced high-quality evidence and reflected Ofwat’s expectations for WTP research. We are confident that one robust and well-designed WTP survey, as part of our phased customer insight and engagement programme, provided the right mix of quantitative and qualitative evidence on which to base our plan. Key to our phased approach was allowing customers to see how their views were influencing our plan – with changes made at each stage in light of what we heard.

We consider that the overall package – and the relative weight of ODIs across our performance commitments – reflects customers' priorities and the relative importance they place on different areas of performance. As noted above we have demonstrated that the ODI rates are driven from WTP research, and where applicable, other reasonable methods of evaluating marginal benefits such as revealed preference data. By reflecting customers' priorities, we are inherently aligning the interests of management and shareholders with customers. This will be further reinforced through strengthening the link between executive pay and the delivery of our package of performance commitments.

The acceptability of overall bill changes – which would include the ODI package – was tested in the same research used to provide WTP results. A simulator tool was provided by the research company that allowed us to test willingness to pay for different service packages (see Appendix A1.3 of our September 2018 Business Plan for more information).

There are limitations to the tool – it can only provide results based on the options tested with customers – but it provides insight into the overall price elasticity of customers based on a set package of service improvements. Below we provide a chart on changes in acceptability of price increases based on a package of service improvements that most closely replicates our final plan.



We have used this insight alongside the Ofwat PR19 methodology to set an overall cap and collar on incentive rates which we describe in more detail in response to action SES.OC.A9.

In the final acceptability testing of the plan we went further and provided additional choices on performance in three areas. Again, this was presented in a transparent way to the customers completing the survey so they could see what the resulting change in the bill would be for them (see Appendix A1.6 of our September 2018 Business Plan for more information).

We therefore consider that the impact of the ODI package on customer bills has been tested with customers as part of the WTP research and the overall business plan acceptability testing. We did not specifically test the concept of outperformance payments and underperformance penalties with our customers as we considered that it was a key part of the Ofwat framework designed to help align the interests of customers, management and shareholders. We were challenged on this point by our CSP and provided our rationale.

We also consider that there is no expectation that outperformance payments will be earned (or penalties incurred) during the 2020 to 2025 period. We are setting stretching targets for all our performance commitments and intend to deliver the targets set.

ODI timing (SES.OC.A7)

No company-wide actions were identified and there were no actions to address on timing for individual performance commitments.

Asset health ODI package

***SES.OC.A8:** The company should provide sufficient evidence that its customers support its proposed asset health outperformance payments. The company should increase its asset health underperformance payments in order to protect customers from poor performance or provide convincing evidence to demonstrate that its current proposals are in the interests of its customers and the assets. The company should provide a clear list of what it considers to be its asset health PCs, and state its P10 underperformance payments and P90 outperformance payments for each of its asset health ODIs in £m and as a percentage of RoRE.*

Our performance commitments and associated ODI rates are driven by customer preferences and customer valuations of the benefits to them based on a survey where they were asked to evaluate packages of service changes and resulting changes to their bill. As the ODI rates are based on our customers' views we consider they are set at appropriate levels. Our past performance is also a strong indicator of the priority we give to maintenance of excellent asset health and we will continue to push the industry frontier in a number of areas.

The majority of our wholesale performance commitments have a direct or indirect link to the health of our assets (and all have a direct link with resilience). In the table below we provide information on each of the performance commitments that we consider are linked to asset health.

Performance commitment	Link to asset health	ODI type
Supply interruptions	Incentivises us to maintain the health of our network of pipes, pumping stations, service reservoirs and related assets	Underperformance penalty and outperformance payment
Leakage	Incentivises us to maintain the health of our network of pipes and related assets	Underperformance penalty and outperformance payment
Mains bursts	Incentivises us to maintain the health of our	Underperformance penalty

	network of pipes, pumping stations and related assets	and outperformance payment
Customer concerns about their water	Incentivises us to maintain the health of our asset from the water source to customers' pipes	Underperformance penalty
Water quality compliance	Incentivises us to maintain the health of our asset from the water source to customers' pipes	Underperformance penalty
Unplanned outages	Incentivises us to maintain the health of our assets at supply points and treatment works	Underperformance penalty*
Pollution incidents	Incentives us to maintain the health of our network from the water source to customers' pipes	Non-financial

* This is a change from our September 2018 business plan – see action SES.OC.A22 for an explanation.

Note, that we have amended App1 in the Business Plan Data Tables to align with the performance commitments above where we consider there is a link to asset health.

On the three performance commitments where the incentive is applied symmetrically, we currently have leading, or near leading, industry performance and we are targeting continued improvement. We therefore consider it appropriate to continue to incentivise additional improvements that will push the industry frontier.

We have re-examined Ofwat's list of asset health metrics and consider that the package of service improvements in our plan remains appropriate. We have decided that additional performance commitments in the following areas are not required for the reasons provided:

- Addressing low pressure: this was not raised as a key concern by customers and our historical performance is within the industry average
- Event Risk Index (ERI): the Drinking Water Inspectorate has recently introduced this measure and it is our preference not to set targets based on new measures that may subsequently be developed. Our score for this new measure is suggesting that improved performance in this area does not need to be incentivised as we are currently leading the industry
- Sub-categories of the Compliance Risk Index (CRI): we consider that targeting the overall CRI provides the greatest incentive to maintain our high levels of performance on water quality compliance. Our historical performance on the sub-category measures has been of an equally high standard
- Unplanned maintenance: we consider that the impact of this is addressed through measuring performance against unplanned outages.

Our engagement activity did not reveal any other areas of concern from our customers or stakeholders in relation to asset health that is not addressed through our suite of asset health related performance commitments listed above.

Customer protection

SES.OC.A9: *The company should apply additional protections through an appropriate outperformance payment sharing mechanism and by implementing caps on individual PCs* *which could result in material outperformance payments. The payment sharing mechanism and caps to material ODIs should be applied in accordance with guidance provided in Technical appendix 1: Delivering outcomes for customers. The company should provide further supporting evidence to set out its approach to bill smoothing so that it is clear how it will work in practice. The company should provide further evidence that explains the maximum payments that customers could be exposed to and what, if any, mitigations are proposed to protect against this outcome.*

Given the level of stretch required to deliver our performance commitment targets we consider there is minimal risk of material exceedance of our targets and resulting bill impacts to customers. However, in response to Ofwat's feedback, we propose to apply an overall cap and collar to the impact of the ODI package. This overall cap and collar will be set at +/- 3% of the annual return on regulatory equity (RoRE) as suggested by Ofwat in its new guidance as part of its Initial Assessment. This means that if outperformance payments for the wholesale business unit go beyond 3% of RoRE in any year then we will share the payment with customers through not applying 50% of the payment to customer bills.

The choice of trigger point for the cap follows the Ofwat guidance but also aligns with our customers' preferences, as provided through our WTP research. The proposed level of 3% of RoRE amounts to a c. £9 annual change on the average bill over the 2020 to 2025 period, or a 4.4% increase. The chart in our response to action SES.OC.A6 shows that this would be an acceptable bill change (based on the package of service improvements in our plan) for c.53% of customers.

We consider that to maintain the incentives on performance and align the interests of customers, management and shareholders the overall cap and collar is applied symmetrically and that the equivalent position is in place for material underperformance.

We are not proposing any changes to individual ODI caps and collars. This position was reviewed and accepted by Frontier Economics in its assessment of the reasonableness of the approach we had taken. The overall cap also achieves the same customer impact in terms of restricting bill impacts not adequately supported by customers.

In addition to the cap described above we will apply bill smoothing in line with Ofwat's charging guidance which currently requires additional actions to be put in place if annual bill changes for any group of customers is expected to exceed 5%.

Addressing Ofwat's specific actions

In this section we address Ofwat's actions relating to our individual performance commitments and ODIs. As in our original submission, we have organised this against our five customer pledges to ensure that the links between them and our performance commitments and ODIs are clear and understood.

Pledge one: High quality water all day, every day

Supply interruptions

We received two actions related to our supply interruptions performance commitment related to the stretch of the target and the ODI rate we proposed.

***SES.OC.A10:** We expect all companies' service levels to reflect the values we have calculated for each year of the 2020 to 2025 period.*

In our September 2018 Business Plan submission, we proposed a performance commitment to reduce supply interruptions that last more than three hours to an average of 2.1 minutes lost per customer, per year, which we considered to be frontier shifting performance for the industry. We have responded to Ofwat's feedback and have reduced our target so it falls in line with the annual performance targets it has set for all companies. This results in our performance commitment changing, so we will now target an average of 3 minutes lost per year by 2024/25.

We did not request any enhancement expenditure to deliver our intended performance improvement and therefore there is no impact on expenditure requirements from changing the target to align with Ofwat's position.

***SES.OC.A11:** The company should explain why its proposed rates differ from our assessment of the reasonable range around the industry average that we set out in Technical appendix 1: Delivering outcomes for customers and demonstrate that this variation is consistent with customers' underlying preferences and priorities for service improvements in supply interruptions. The company should also provide the additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for supply interruptions and assess the appropriateness of the company's customer valuation evidence supporting its ODI.*

We are not changing the ODI rates as they are calculated in line with the Ofwat methodology and use information received from our customers on their willingness to pay for service improvements. Frontier Economics reviewed the calculation and found no issue. The review can be found in Appendix A.OC2, section 2.3.2.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

Mains bursts

We received two actions associated with our performance commitment for water mains bursts related to the ODI type and rate.

SES.OC.A17: The company should provide further evidence to justify the use of an outperformance payment for this PC, including evidence of customer support.

In our willingness to pay research, customers supported investment on pipe replacement in the context that it would reduce the number of bursts. We therefore consider that there is customer support for outperformance payments in this area. Information on the research carried out and the results can be found in Appendix A1.3 of our September 2018 Business Plan.

***SES.OC.A18:** The company should explain and evidence how its proposed ODI rates for mains bursts are coherent with the rates proposed for PCs relating to the associated customer facing-impacts of the asset failure (including leakage and supply interruptions) and demonstrate how the package of ODIs across the relevant group of PCs appropriately incentivises performance in the long and short- term. The company should also provide the* *additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for mains bursts and assess the appropriateness of the company's customer valuation evidence supporting its ODI.*

We are not changing the ODI rates as they are calculated in line with the Ofwat methodology and use information received from our customers on their willingness to pay for service improvements. Frontier Economics reviewed the calculation and found no issue. The review can be found in Appendix A.OC2, section 2.3.2.

Our package of ODIs related to asset health is explained in our response to action SES.OC.A8. Bursts do not always create supply interruptions or affect leakage but do have additional detriment to customers. The impact of bursts affects road users – be that drivers, public transport users, pedestrians or nearby residents; and can impact on the environment through pollutions to neighbouring watercourses. They are one of the most frequent reasons we are contacted on social media platforms. Customers have therefore demonstrated to us that the number of bursts is an important area to target alongside supply interruptions and leakage.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

Customer concerns about their water

We received two actions related to our performance commitment that addresses customers' concerns about the taste, smell and appearance of their water. They relate to the stretch of the performance commitment and the ODI rate proposed.

SES.OC.A24: *Customer concerns about their water PC: The company should revise its performance levels to be more stretching, at least beyond current performance levels, and provide sufficient evidence for its revised level. If the company does not think that a more stretching performance level is suitable, it should clearly set out the rationale for its position and provide sufficient evidence to underpin its decision.*

We consider that the target in our plan is stretching. We will maintain our target to receive no more than 0.5 contacts per 1,000 people about the taste, smell or appearance of their water.

In the current period, the performance commitment we made has been a challenge to meet. In two out of the last four years we have incurred a penalty and in the other two years performance has been within the deadband (meaning performance has been below target but no penalty has been incurred). This is despite our performance being amongst the best in the industry. The following table summarises our performance.

	2015/16	2016/17	2017/18	2018/19
Our performance (no of contacts)	419	375	365	388
Contacts per 1,000 people	0.62	0.55	0.53	0.56
Position in industry	3	1	3	3

The target we have set for 2020/21 to 2024/25 is beyond current performance levels and we do not agree with Ofwat's comment that historical performance is 20% better than we are forecasting. The table below shows the derivation of the performance target which can be compared to historical performance in the table above.

Please note that as defined, the population used in the calculation of contact rate is the annual average population reported for the last complete financial year, which is reported to the Drinking Water Inspectorate when establishing the sampling programme for the forthcoming year.

	2020/21	2021/22	2022/23	2023/24	2024/25
Contacts	365	365	365	365	365
Population	713,153	718,844	724,685	730,705	736,655
Contacts per 1,000 people	0.51	0.51	0.50	0.50	0.50

This demonstrates that we are targeting a level of performance better than the average performance we have achieved over the last four years. We are committed to achieving this at no additional cost as demonstrated by not requesting funding for enhancement in this area.

Furthermore, it is important to note that meeting out target, which represents upper quartile industry performance, will be more stretching for the 2020/21 to 2024/25 period as we are planning more activity on our network, which can temporarily impact on the taste and appearance of the water we deliver if not managed appropriately and has the potential to result in additional customer contact. We will therefore need to mitigate this additional risk through effective operational activity and customer communications.

SES.OC.A25: *The company should provide further evidence to justify the use of PR14 rates or update these rates based upon more recent customer engagement evidence and forecast efficient marginal costs. In either case the company should provide its evidence and rationale.*

We are not changing the ODI rates as they are calculated in line with the Ofwat methodology. Frontier Economics reviewed the calculation and found no issue. The review can be found in Appendix A.OC2, section 2.3.2.

We did not test water quality contacts with our customers in our WTP research conducted for the PR19 Business Plan and therefore we have relied on previous research to set the ODI rate. The reason we did not test this area was that qualitative customer engagement showed that water quality was still a high priority and we considered that given this, and its relatively high performance, customers would consider it a requirement to provide the highest level of service rather than an area where they could meaningfully choose a different level.

Water quality compliance

We received two actions related to our performance commitment for water quality compliance as measured by the Drinking Water Inspectorate's new compliance risk index (CRI). They relate to the ODI rate and the caps, collars and deadbands proposed.

***SES.OC.A19:** Water quality compliance PC: The company should provide the additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for water quality compliance and assess the appropriateness of the company's customer valuation evidence supporting its ODI. The company should explain and evidence how its proposed ODI rate for CRI is coherent with the rates proposed for other asset health PCs.*

Frontier Economics reviewed the calculation of the ODI rate proposed. It has recommended that we change the underperformance penalty rate. This follows a review of evidence following the Initial Assessment and concerns the marginal cost value used to set the ODI rate. Further detail can be found in Appendix A.OC2, section 2.3.2.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

***SES.OC.A20:** Water quality compliance PC: We propose to intervene to ensure companies perform to the regulatory requirement of 100% compliance against drinking water standards. As set out in the methodology we noted a deadband may be appropriate. It is important that the range of underperformance to the collar is adequate to provide clear incentives for companies to deliver statutory requirements. The company should set a deadband at 1.50 and collar at 9.5 for 2020-25.*

We accept the proposed deadband of 1.5 and collar of 9.5 on the basis that this is applied across the industry. We have revised these values in App1 of the Business Plan Data Tables accordingly.

This is a new metric and we are currently performing well against it. However, given the variations in performance that can manifest from single failures at larger assets/those serving larger populations, there is potential that an underperformance penalty could be received as a result of a single compliance failure. So there remains material risk of a financial penalty on this measure even though we have reduced the magnitude of the ODI.

Customer confidence

We received one action relating to our performance commitment measuring customer confidence.

***SES.OC.A26:** The company should provide further justification of why this PC is required in addition to C-MeX.*

We have removed this performance commitment as a result of Ofwat's feedback. We accept that this will be addressed through the new C-MeX performance commitment. We will continue to track customer confidence as part of our ongoing engagement programme and report the results on a regular basis to our Board and Customer Scrutiny Panel.

Pledge two: Fair prices and help when you need it

Supporting customers in financial hardship

We received an action relating to the stretch of our performance commitment to increase the number of people who benefit financially from our Water Support Scheme.

SES.OC.A27: *Supporting customers in financial hardship PC: The company should revise the target for this PC to make it more stretching as the original proposed target was higher (25,000) If the company does not think that a more stretching performance level is suitable, it should clearly set out the rationale for its position and provide sufficient evidence to underpin its decision.*

We are committed to supporting customers experiencing financial hardship. It is an area in which we have made considerable progress over recent years and are exceeding our current target, providing more financial support to customers through our Water Support Scheme. This additional support is funded by shareholders.

We consider that our proposed target of 19,000 is appropriate and will see the number of customers on the Water Support Scheme significantly increase over the five year period. We tested different levels of support with customers as there is an impact on customer bills. We provided customers with the opportunity to feedback on their preferred level of activity for usage reductions, leakage and level of financial support as part of the acceptability testing of our draft Business Plan. As a result we took the decision to do less in this area and target helping 19,000 customers in financial hardship which enabled us to better reflect customer expectations for us to do more to reduce leakage and usage. We consider this to be an appropriate trade-off and we discussed the position with the CSP prior to submission of the plan and again following the Ofwat's Initial Assessment. The CSP considered this approach reasonable.

If additional customers qualify for the scheme beyond the target we have set we will continue to accept them onto the scheme and the shortfall in funding will be paid for by shareholders, as it is now.

Vulnerable support scheme awareness

We received two actions associated with our performance commitment to increase awareness of our Helping Hand Scheme and Priority Services Register, related to the definition and stretch of the performance commitment.

SES.OC.A28: *The company should provide evidence of the sample size used in the annual survey to determine the PC target.*

In our September 2018 Business Plan we explained the approach we would take to measuring this performance commitment. We stated that a robust sample size will be set and quotas will be included to ensure that in total the respondents represent our customer base, e.g. age, socio-economic group, location. The method of surveying customers, e.g. online, phone, will be chosen to achieve a robust and representative sample. Both the survey method and sample size will be set in advance each year. The survey will be undertaken on our behalf by an independent, expert third party and we consider it appropriate that they set the sample size at the time the survey is conducted rather than it being fixed and included in the definition of the performance commitment.

Therefore, we have not provided evidence of the sample size we will use in the annual survey but in response to Ofwat's action we have added a minimum sample size of 400 to the definition.

The revised definition of this performance commitment can be found in Appendix A.OC1.

SES.OC.A29: *The company should revise its proposed performance levels to make them more ambitious or provide compelling evidence why it is in the interests of customers not to do so.*

We have reviewed the target we proposed in our September 2018 Business Plan and have made it more stretching. Our original plan proposed that we would increase vulnerable support scheme awareness to 58% by 2025. We have revised our performance commitment and will now target 68% - a further 10% uplift - by 2025.

We based our original target on the trend of increased awareness that we have seen since 2013/14, which has resulted in an average of 43% awareness. Having analysed the figures more closely, over the last five years there have been points where awareness has increased more significantly. This includes when we initially promoted our Water Support Scheme in 2014/15 - awareness increased from 23% to 51%; and likewise, when we carried out work in 2018 to transition 11,000 housing association residents onto direct billing - awareness of the help schemes we offer rose from 44% to 51%. Therefore we accept that with appropriate and targeted activity we can reach more customers so we should be more ambitious in this area.

To achieve this we will promote and enhance the service we offer to customers through:

- Online campaigning
- Bill redesign including tailored information about priority services and help schemes
- Regular account statements including priority service and help scheme information
- Increasing public presence and partnerships with local authorities through our customer liaison team
- Providing information to customers through our metering programme that will reach more than 90,000 households over the five year period.

Vulnerable support schemes helpfulness

We received two actions relating to our performance commitment to ensure that our Helping Hand Scheme and Priority Services Register is helpful to customers. They related to definition of the performance commitment.

SES.OC.A30: *The company should revise its approach to assessing helpfulness of support schemes to better understand what the issues actually are and what improvements can be made to improve services. The company should provide evidence on survey methodology for this PC. Specifically this should cover the question asked to customers and the sample size.*

In our September 2018 Business Plan we explained the approach we would take to measuring this performance commitment. We stated that a robust sample size will be set and quotas will be included to ensure that in total the respondents represent our customer base, e.g. age, socio-economic group, location. The method of surveying customers, e.g. online, phone, will be chosen to achieve a robust and representative sample. Both the survey method and sample size will be set in advance each year. The survey will be undertaken on our behalf by an independent, expert third party and we consider it appropriate that they set the sample size at the time the survey is conducted rather than it being fixed and included in the definition of the performance commitment.

Therefore, we have not provided evidence of the sample size we will use in the annual survey but in response to Ofwat's action we have added a minimum sample size of 400 to the definition.

In addition to measuring performance based on this commitment we will look to continually improve the services we offer by seeking feedback from customers and stakeholders as part of our ongoing customer insight programme. This is likely to include targeted engagement with customers that have accessed the services and those organisations that support customers that are more likely to access the service,

SES.OC.A31: *Vulnerable support scheme helpfulness PC: The PC should only include surveying customers who accessed the services in relation to the survey.*

We do not agree that this is the right approach to setting the target for this performance commitment. By measuring actual and perceived helpfulness of our vulnerable support schemes we will better understand the opinions of a more diverse group of customers and we won't have to specifically target surveys at those using the scheme.

We accept that the main driver is to ensure that the scheme is considered helpful by those that are already using it but we also consider that there is value to be gained by understanding the views of those who aren't. This is because vulnerability is a dynamic issue and any customer could enter a state of vulnerability at any given time for a range of different reasons such as unemployment, divorce, bereavement, accident or illness. By testing the views of those not on the schemes, but who may need to access services in the future, we will receive richer insight and it will enable us to continue to shape what we offer to meet our customers' needs. It is also another way of raising awareness of the help we offer to a wider audience.

Deliver value for money

We received two actions associated with the stretch of our performance commitment to measure customers' perception of value for money and the ODI type we proposed.

SES.OC.A35: *The company should review the targets for this PC in the 2020-2025 period, taking into account recent performance. The company should increase the stretch of the target to improve on current performance, as it is currently already meeting the target of <10% of customers feeling that the company does not provide value for money. The company should provide sufficient justification for its revised targets.*

We have removed this performance commitment from our Business Plan in response to the two actions received.

We will continue to closely monitor customer attitudes to their bill and perceived value for money through our own engagement and through CCWater's annual survey and we will actively report our performance to stakeholders.

SES.OC.A36: *The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach. The company should demonstrate how a non-financial incentive will benefit customers. If it cannot do this, the company should propose a financial ODI.*

We have removed this performance commitment from our business plan as we consider that applying a financial incentive is not appropriate because there are a number of factors outside of our control that will impact on our customers' views on the value for money they receive, e.g. the general economic climate and a customers' own financial situation. We have also concluded that many of the aspects within our control (level of service) are already captured through other financial incentives such as performance on supply interruptions, leakage and customer satisfaction which will have an impact on a customer's perception of the value for money of the service they receive.

Managing bad debt

We received three actions on our performance commitment to manage bad debt, relating to the definition and stretch of the performance commitment and the ODI type proposed.

SES.OC.A32: *The company should provide further justification for having this PC and why it is appropriate despite low customer support.*

We have removed this performance commitment from our Business Plan. We accept that it has low customer support and therefore does not best represent our customers' priorities.

SES.OC.A33: *The company should provide further justification for targeting deteriorating performance. If it cannot do this, it should set a stretching target to improve performance, and provide sufficient evidence for its target.*

We have removed this performance commitment from our Business Plan. We accept that it has low customer support and therefore does not best represent our customers' priorities.

SES.OC.A34: *The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach. The company should demonstrate how a non-financial incentive will benefit customers.*

We have removed this performance commitment from our Business Plan. We accept that it has low customer support and therefore does not best represent our customers' priorities.

Void properties

We received one action on the ODI type proposed for this performance commitment to reduce the number of properties that are connected to our network but shown as vacant (void) so not billed.

SES.OC.A37: *The company should provide evidence to demonstrate that an outperformance payment would benefit customers and that it is designed in such a way that does not create perverse incentives with respect to the timely and accurate registration of void sites. The company should remove the outperformance payment if it cannot provide this evidence.*

Frontier Economics reviewed the outperformance payment and underperformance penalty rates. This review confirms that an outperformance payment is appropriate as there is a benefit to customers because when more properties are correctly billed, it reduces the average bill for all customers. The WTP research we carried out showed that bills are the most important factor for customers so incentivising outperformance against this measure will bring benefits to customers in an area that matters most to them.

There is no perverse incentive as the process of registering properties on our system is separate from the process of seeking customers' details to allow for the property to be converted from a void to a billable property.

The incentive rate has been revised as it previously applied a 50% sharing factor which should not have been applied to a retail specific performance commitment.

Pledge three: A service that is fit for the future

Risk of severe restrictions in a drought

There is no action for this performance commitment but it is included in the company-wide action on ODI type (SES.OC.A2).

Risk of supply failures

The actions associated with our performance commitment to reduce the risk of supply failures by increasing the connectivity of our infrastructure to ensure all customers can be supplied by more than one treatment works, relate to the stretch of the target and the ODI rate proposed.

SES.OC.A38: *The company should provide sufficient evidence that its PC target is stretching. If it cannot do this then it should increase the stretch of its target.*

We have put forward a stretching and ambitious performance commitment which will increase the resilience of the service we supply to our customers. It is linked to the completion of a three-AMP resilience programme that is delivering a series of network enhancements to improve the connectivity of our network so our service is more resilient to short-term events such as the March 2018 freeze/thaw and the management of medium-term events such as droughts. Further details about the work involved can be found in the Wholesale chapter of our September 2018 Business Plan.

Once complete, we will be able to supply all our customers with water from more than one treatment works, providing complete supply resilience without interruption in the event of an outage at any of our eight treatment works. Our performance commitment target is for 100% of customers to be supplied by more than one treatment works by 2024/25. We consider this a stretching target for the following reasons:

- It involves carrying out major upgrade works at two of our most strategic pumping stations. This work will need to be done whilst maintaining normal operations and strategically planned and scheduled to minimise risk of disruption to customers. For example, we would not carry out work on both pumping stations at the same time and there are certain periods during the year that will need to be avoided due to the increased risk that an operational event may occur. This means that work has been carefully planned over the AMP and will need to remain flexible as external factors such as weather conditions may lead to changes in the plan
- The scheme involves significant work to complete the upgrading and increases in treatment capacity at our Bough Beech Treatment Works. It will need to remain operational throughout as by the end of AMP6 it will supply more than 70,000 customers and is our only surface water treatment works which means that at certain times of the year we need to be able to maximise and maintain our output to protect our groundwater sources
- We will be laying a new strategic main linking two reservoir zones. This main will need to be laid in an urban environment with many access restrictions. Effective communications and stakeholder engagement will be required to deliver the scheme on time and on budget
- All of the major works as part of this programme will need to be done on and around existing assets. Whilst this is more cost effective than installing new assets, if not carefully managed it has the potential to impact on other performance commitments, including C-MeX and supply interruptions and timescales to deliver the work have been set to reflect this.

Our priority is delivering this important work in the most cost effective way without compromising the resilience of our service while it is undertaken. It is for this reason that we consider the target to be stretching and will deliver the best outcome for our customers, both in the short and longer term.

Once complete we will be one of the only water companies in the UK to have this level of strategic resilience (we will be able to supply all customers from two treatment works). It will enable us to withstand shock events in the form of unplanned outages, mitigate climatic events including drought and freeze/thaw and commercial shocks such as those posed by a no-deal Brexit which may affect our ability to keep our water treatment works running at full capacity. It also contributes to increasing the connectivity of the wider region and has been included in the modelling carried out by Water Resources South East to identify future strategic water resources and transfers needed to make the region more resilient and protect the environment.

The target we have proposed is supported by our customers, having been directly tested through our qualitative and quantitative customer engagement. Not only do customers support the work but they are willing to fund it through bills as part of a balanced package of measures to improve the reliability of their future water supply.

SES.OC.A39: *The company should provide further evidence to demonstrate the methodology used to calculate the ODI rates proposed. The company should provide further evidence to justify the use of ODI outperformance payments, in particular how this relates to the enhancement expenditure proposed in this area.*

We are not changing the ODI rates as they are calculated in line with the Ofwat methodology and use information from our customers on their willingness to pay for service improvements. Frontier Economics reviewed the calculation and found no issue. The review can be found in Appendix A.OC2, section 2.3.2.

The enhancement expenditure for resilience has been used to set the marginal cost included in the calculation of ODI rates. It includes some costs incurred in the final year of the current AMP as that work is necessary to deliver the initial change in the target and has been brought forward into this AMP for the planning reasons highlighted in the bullet points above.

Unplanned outages at treatment works

We received three actions associated with our performance commitment for unplanned outages at our treatment works related to provision of 2018/19 data and the ODI type and rate proposed.

SES.OC.A21: *The company is required to provide fully audited 2018-19 performance data by 15 May 2019. This should take the form of an early APR submission, but only for Unplanned Outages. Board assured data can be provided with the main APR in July 2019, any changes will be taken into account for the Final Determination. Based on the latest performance and updated methodologies, the company should re-submit 2019/20 – 2024/25 forecast data in the 15 May 2019 submission. The company should also report their current and forecast company level peak week production capacity (Ml/d), the unplanned outage (Ml/d) and planned outage (Ml/d) in their commentary for the May submission.*

The data will be provided in the 15 May 2019 submission and the industry developed consistent method of calculation will be applied.

SES.OC.A22: *The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach. If it cannot do this, the company should propose a financial ODI.*

We have revised our original plan to include an underperformance penalty for this performance commitment. Our original rationale for not making this a financial ODI was because of the overlap with our bespoke performance commitment to reduce the risk of supply failures. However, we recognise that including an underperformance penalty will further incentivise strong performance and reduce the risk that our customers will experience loss of supply – something which is a priority for them.

SES.OC.A23: *The company should propose a financial underperformance incentive and explain and evidence how its proposed ODI rate is coherent with the rates proposed for PCs relating to the associated customer facing- impacts of the asset failure and demonstrate how the package of ODIs across the relevant group of PCs appropriately incentivises performance in the long and short- term. The company should also provide the additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for unplanned outages and assess the appropriateness of the company's customer valuation evidence supporting its ODI.*

We have calculated a rate for this ODI in line with Frontier Economics' recommendation. The recommendation can be found in Appendix A.OC2, section 3.1.2.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

Leakage

We received three actions associated with a performance commitment to reduce leakage. They relate to the ODI type and rate and its position as an enhanced ODI.

SES.OC.A12: *The company should provide further evidence to justify the use of an outperformance payment for this PC, including evidence of customer support.*

Reducing leakage is consistently highlighted as a priority for customers and is an area that regulators and stakeholders have set increasingly high expectations. We have consistently been one of the best performing companies in the industry on this measure and our target to reduce leakage by 15% is considerably more ambitious than those set previously, reflecting the importance our customers and stakeholders place on this area of service. In the acceptability testing of our draft Business Plan, details of which can be found in the Engaging with our customers chapter and appendix A1.6 of our September 2018 submission, customers clearly signalled that they expected us to do more. As a result we increased our target from 12% to 15%, while keeping our proposed bill the same, through a trade-off with other service improvements. It must also be seen in the longer-term context as we have committed to reducing leakage by at least half by 2045, which was recommended by the National Infrastructure Commission in its report 'Preparing for a drier future'.

We consider that an outperformance payment is justified based on the WTP research results, which can be found in appendix A1.3 of our September 2018 submission, and the additional acceptability testing carried out before finalising our September 2018 Business Plan. It provides an incentive to further improve service levels in an area that matters most to customers and to make progress against our longer term target more quickly which is an important part of securing the long-term resilience of water supplies.

SES.OC.A13: *The company should explain why its proposed rates differ from our assessment of the reasonable range around the industry average that we set out in Technical appendix 1: Delivering outcomes for customers and demonstrate that this variation is consistent with customers' underlying preferences and priorities for service improvements in leakage. The company should also provide the additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for leakage and assess the appropriateness of the company's customer valuation evidence supporting its ODI.*

We are not changing the ODI rates as they are calculated in line with the Ofwat methodology and use information received from our customers on their willingness to pay for service improvements. Frontier Economics reviewed the calculation and found no issue. The review can be found in Appendix A.OC2, section 2.3.2.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

SES.OC.A14: *The company should set out the performance thresholds for enhanced outperformance and underperformance incentives, and provide evidence demonstrating that these are consistent with both shifting the frontier and protecting its own customers.*

The level at which the enhanced outperformance payment and underperformance penalties start were set at 75% better or worse reductions from the annual percentage reduction reflected in our plan. This is reflected in the values included in App1 of the Business Plan Data Tables.

We consider that setting the enhanced payment and penalty thresholds at this level ensures that we have incentives to continue to push the industry upper quartile which will benefit all water customers, not just our own.

We have one of the lowest leakage levels in the industry at 83 litres per property per day. The current industry average is 123 litres per property per day. The enhanced outperformance payment will only apply if we meet a leakage level of 61 litres per property per day which is almost half the current average industry leakage level. We have also capped the outperformance payments available for leakage to protect customers from unlikely but material outperformance.

Pledge four: Excellent service, whenever and however you need it

First contact resolution

We received three actions related to our performance commitment to reduce the number of times customers have to contact us about the same issue, related to the stretch of the target and the ODI type and rate proposed.

SES.OC.A40: *The company should provide justification for its committed performance level.*

We consider that our commitment to resolve 85% of customer contacts first time is stretching. Our current performance for this measure is 76.7% so our plan proposes an 8.3% uplift over the five-year period to reach 85% by 2025. We have targeted this level of performance based on a review of research by the Institute of Customer Service that shows that companies within the Retail – Non-Food sector are the leading performers against their 'Right First Time' measure, achieving an average performance of 83.5% for first time resolution. This compares to an average of 78.5% across all other UK sectors.

Although we recognise that within this group there are some exceptional performers achieving 90+% first time resolution, we consider 85% to be stretching given the nature of the service we provide and that many customer contacts, such as to report a leak or supply problem, cannot always be resolved through one call. We will need to investigate and ensure that we proactively contact the customer quickly and efficiently to provide a high-quality service and reduce the need for them to re-contact us.

It is also important to note that the number of unwanted contacts we receive has been an area of challenge for us over recent years. In CCWater's 2017/18 report we were the worst performing water only company, receiving 983 unwanted contacts per 10,000 connected properties. We are making progress to improve this and continue to report regularly to CCWater on our performance. Therefore, our work in this area is two-fold: to reduce the number of unwanted contacts we receive, while also prioritising resolving those that we do quickly. Together this will drive a step-change in the performance we provide our customers.

SES.OC.A41: *The company should provide further evidence to justify the use of an outperformance payment for this PC, including evidence of customer support. The company should provide justification for not including digital channels. If it cannot do this, it should include digital channels.*

Customers value their time and therefore our outperformance payment has been set based on the time that customers will save if they do not have to make repeat contacts. The calculation approach is included in the Frontier Economics report at Appendix A.OC2, section 2.3.2.

SES.OC.A42: *The company should either provide further evidence to justify the existing methodology or refine ODI rates in line with direct customer willingness to pay evidence. In either case the company should provide its evidence and rationale.*

Frontier Economics carried out a review of the ODI rates proposed. The use of a revealed preference approach to set the ODI rate was considered reasonable. It recommends changing the ODI rate based on using a more robust data on consumer earnings in the calculation of ODI rates. We have accepted the recommendation which can be found in Appendix A.OC2, section 2.3.2.

Pledge five: Supporting a thriving environment we can all rely upon

Usage (per capita consumption)

We received two actions related to the ODI type and rate that we proposed for our performance commitment to help customers reduce their consumption.

SES.OC.A15: *The company should provide further evidence to justify the use of an outperformance payment for this PC, including evidence of customer support.*

Reducing customer usage is an area that customers consistently highlighted as important through the customer engagement programme. It was tested as part of the WTP research through questions related to support for metering as a means of reducing consumption. Qualitative research also highlighted that metering is an area of importance for customers. In the acceptability testing of our draft Business Plan, customers signalled that they expect us to do more to help them reduce their usage than we originally proposed. As a result we increased our usage reduction target from 6% to 7.3% while keeping our proposed bill the same, through a trade-off with other service improvements.

Reducing customer usage is an area where regulators and stakeholders have set increasingly high expectations. It must also be seen in the longer-term context as we have committed to reducing per capita consumption to 118 litres per person per day by 2050, in line with recommendations made by the National Infrastructure Commission in its report ‘Preparing for a drier future’. The Government has also indicated that it intends to set a personal consumption target.

We consider that an outperformance payment is justified based on the WTP research results and the additional acceptability testing carried out before finalising our September 2018

Business Plan. It provides an incentive to further improve service levels in an area that matters most to customers and make progress against our longer term target more quickly which is an important part of securing the long-term resilience of water supplies.

SES.OC.A16: *The company should explain why its proposed rates differ from our assessment of the reasonable range around the industry average that we set out in Technical appendix 1: Delivering outcomes for customers and demonstrate that this variation is consistent with customers' underlying preferences and priorities for service improvements in per capita consumption. The company should also provide the additional information set out in Technical appendix 1: Delivering outcomes for customers to allow us to better understand the causes of variation in ODI rates for per capita consumption and assess the appropriateness of the company's customer valuation evidence supporting its ODI.*

We have made minor changes to the ODI rates as a result of some calculation issues identified by Frontier Economics in its review. The rates were calculated in line with the Ofwat methodology and use information received from our customers on their willingness to pay for service improvements, however there was an issue in relation to the conversion from a whole company value to a household only value. We have also updated the marginal cost value to align with the updated Business Plan. The Frontier Economics review and resulting ODI rates can be found in Appendix A.OC2, section 2.3.2.

Further information on ODI rate derivation is provided in the amended Business Plan Data Tables App1, App1a and App1b.

Greenhouse gas emissions

We received one action associated with the ODI type we proposed for our performance commitment to generate and use renewable energy to limit the greenhouse gas we create from our operations.

SES.OC.A43: *The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach. The company should demonstrate how a non-financial incentive will benefit customers*.

Our performance commitment for greenhouse gas emissions is to invest in and purchase renewable energy to limit our emissions to 55kg of CO_2 equivalent per million litres of water put into supply. The reason for this being a non-financial ODI is because by only using renewable sources, with effect from summer 2018, we have limited our ability to further reduce emissions. Frontier Economics reviewed the decision to make this a non-financial ODI and have confirmed that our reasoning is justified.

Pollution incidents

There is no action for this performance commitment but it is included in the company-wide action on ODI type (SES.OC.A2).

Abstracting water to treat (Abstraction Incentive Mechanism)

We received two actions associated with our performance commitment to reduce the amount of water we abstract from more environmentally sensitive water sources when river flows are low, which is based on the principles of the Abstraction Incentive Mechanism (AIM). They relate to the stretch of our target and the ODI type proposed.

SES.OC.A44: *The company should provide further evidence on how the target performance level was calculated within the adapted AIM methodology.*

The Abstraction Incentive Mechanism (AIM) encourages water companies to reduce the environmental impact of abstracting water at environmentally sensitive sites during periods of low surface water flows. In February 2016, Ofwat produced guidelines on the AIM which included, as a first step, the identification of appropriate AIM sites.

We reviewed our abstraction sites against the AIM guidelines but none were deemed suitable for applying the guidelines. The Ofwat guidelines specify that water companies should consider schemes that are included in the Water Industry National Environment Programme (WINEP). For us this meant considering the Wandle and the Darent catchments. We then applied the filters identified by Ofwat which resulted in the Darent being discounted as low flows are linked to abstraction by Thames Water and South East Water, not ourselves. The Wandle was also discounted as there is an existing augmentation scheme that masks abstraction in the catchment. The augmentation scheme means we recirculate water from downstream to the upper reaches of the river.

However, as we are committed to the objective of abstracting water in a sustainable manner and protecting environmentally sensitive sites, we have adapted the AIM methodology and included a performance commitment for this area.

In conjunction with Thames Water, we commissioned Mott MacDonald to carry out a study on options which would improve low flows or ecological status in the River Wandle, a chalk stream in the Thames catchment. This followed previous research on the impact of groundwater abstraction in the catchment (by the companies individually) and a joint catchment-wide review. The research identified that there was a strong correlation between groundwater levels at our observation borehole at Well House Inn and river flows in the Carshalton branch of the Wandle, particularly when levels fall below 89m above ordnance datum (AOD), equivalent to 43.2m below ground level. Between 1994 and 2013 the level fell below this point on average 74.5 days per year – around 20% of the time.

The studies also showed that abstraction from our boreholes at The Oaks and Woodcote had the most significant and most immediate impacts on the flows to the headwaters of the river. Therefore we have selected these sites to be used in our adapted AIM performance commitment. As explained above, we augment the river at its headwaters using river water from further down the catchment so these sites do not meet the criteria as set out in Ofwat's guidelines and that is why this performance commitment is an adapted version of the AIM.

We selected a target performance abstraction level of 7 Ml/d on average and 12 Ml/d at peak when the trigger level has been reached, which compares to our licensed limit of 9.1 Ml/d on average and 19.6 Ml/d at peak – a reduction of 23% and 39% respectively. This would have reduced abstraction by 15% between 2015/16 and 2017/18 – even though none of these years were classed as a 'dry year'. As such the AIM scheme proposed requires a substantial change in operations with demand being met from other sources within and outside the catchment, particularly in drier conditions. Whilst we have some flexibility in the selection of sources which supply this area, and we are increasing our ability to move water around our network which would increase flexibility further, we consider the limit on abstraction proposed is sufficiently challenging and meets the objectives of AIM. A further reduction in abstraction is likely to constrain our ability to carry out artificial recharge into the confined chalk aquifer, since The Oaks and Woodcote boreholes are the primary sources used in this process.

We will carry out in-depth monitoring of the impact of the AIM scheme as part of our ongoing WINEP work to determine if the target performance level is appropriate and driving the right approach in terms of protecting levels in the River Wandle, in order to prevent deterioration in ecological potential of the Carshalton Branch and to improve ecological potential in the Beddington Branch (from Croydon to Wandsworth).

In addition to the limit on abstraction, we have committed to maintaining the augmentation flow (for example through additional back-up to deal with the risk of power outages) since we recognise that this recirculation system is critical to the health of the river, especially for fish including trout.

The process we have followed has been undertaken transparently through engagement with environmental stakeholders including the Environment Agency and South East Rivers Trust as specified in Ofwat's guidelines.

The reports referenced in this action response can be found at Appendices A.OC1, A.OC2 and A.OC3.

SES.OC.A45: *The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach.*

None of our sites met the criteria and guidelines from Ofwat for the AIM. In the River Wandle, the site of our adapted AIM performance commitment, we augment the upper reaches through recirculation of water from downstream. Therefore although our adapted AIM performance commitment will have some benefit in terms of increasing natural flow to the headwaters, it is unlikely to substantially improve river flows since the augmentation will counter-balance this effect. We therefore do not consider it appropriate to be financially rewarded for meeting this performance commitment as we cannot confirm there is a measureable environmental benefit. However, through the data that will be collated once the adapted AIM is in operation, we will be able to investigate this and determine if a benefit can be quantified. We can utilise this information to refine any future AIM performance commitment in this catchment or the introduction of other AIM schemes through the findings of the later phases of WINEP work.

The Environment Agency (EA) and the South East Rivers Trust support our approach to developing an adapted AIM performance commitment, despite not having any sites which meet the required AIM criteria. Two representatives from these organisations are members of our Customer Scrutiny Panel. The EA views the proposed AIM as a suitable temporary measure to protect against low flows in the River Wandle until the benefit of the options put forward for funding under the WINEP are realised. Both organisations were involved in reviewing the results of the studies which demonstrated that abstraction at The Oaks and

Woodcote boreholes had the most immediate and significant impact on groundwater flows to the Carshalton branch of the River Wandle.

We also received support for our approach to developing this performance commitment by other members of our Customer Scrutiny Panel in July 2018 as part of the general engagement process on all of our performance commitments.

Improving land through biodiversity

We received no actions associated with our performance commitment to make the land we own more attractive to a variety of plant and animal life through achieving and maintaining The Wildlife Trust's Biodiversity Benchmark at three of our treatment works.

Improving rivers through the delivery of WINEP

We received one action related to the ODI type we proposed for our performance commitment to deliver the requirements of the Environment Agency's Water Industry National Environment Programme (WINEP).

***SES.OC.A46:** The company should provide further evidence to justify the use of a non-financial incentive for this PC and evidence of customer support for this approach. The company should demonstrate how a non-financial incentive will benefit customers.*

We maintain that a non-financial ODI is appropriate for the performance commitment associated with the delivery of the 24 river-based investigations or improvement programmes identified under WINEP. This is because WINEP is a statutory programme overseen and enforced by the Environment Agency, with strong reputational incentives associated with its delivery.

The Environment Agency has the power to change what the company needs to deliver under WINEP, following the final determination and the confirmation of ODIs. Therefore, this would put us at risk of both financial penalties and rewards if changes were made to the scope of WINEP which are outside of our control. Frontier Economics considered this as part of its review of our ODIs and agrees that it is a reasonable concern. A financial ODI for this performance commitment could see customers exposed to higher bills should the WINEP programme be scaled down by the Environment Agency, making the target less stretching but still subject to an outperformance payment. Likewise if more is added to the programme the company faces an underperformance penalty if it fails to deliver. Therefore, maintaining this as a reputational ODI protects customers from bill changes but a strong incentive remains under the high-profile and statutory nature of this commitment.

CHAPTER 3

Securing long-term resilience

Securing long-term resilience

Delivering resilience in the round was a key theme of our September 2018 Business Plan. We have a strong track record in providing resilient and reliable services to our customers which is the result of ongoing, far sighted planning and prioritisation of risk mitigations, targeted and appropriate investment and an effective and organised business response when issues occur.

Activity to further increase resilience is a key feature of our plan and is a core theme within our package of performance commitments and ODIs, enabling delivery for customers and protecting the environment.

In our September 2018 Business Plan submission, we set out how we had taken a more holistic view of the risks that could impact on our business, embracing the concept of resilience in the round – covering operational, financial and corporate risks. Our assessment and prioritisation of risks was detailed in chapter 7 of our September 2018 submission, and supported by Appendix A7.1. We also explained how we have applied the Cabinet Office's classification of resilience activities – the '4Rs' (resistance, reliability, redundancy and response & recovery) - to mitigate the risks we face. We highlighted the activity and investment included within our plan to secure resilience through a mix of mitigations and also how we are developing a company-wide ethos of considering resilience in everything we do.

In its Initial Assessment of our plan, Ofwat identified four required actions for us to address in our resubmission to demonstrate that we will secure long-term resilience through our Business Plan for 2020 to 2025. They included clearly defining which of our performance commitments are associated with operational resilience, ensuring they are sufficiently demanding and that there is a line of sight between risks to resilience and our package of outcomes.

In addition, Ofwat require us to commit to providing an action plan, by 22 August 2019, to implement a systems-based approach to resilience in the round and demonstrate we have an integrated resilience framework that underpins our operations and future plans. We are also required to commit to working with the sector to develop robust, forward-looking asset health metrics and provide greater transparency of how our asset health indicators influence our operational decision making.

Finally, we have been asked to explain the steps the company and its Board are taking to maintain long-term financial resilience in the event that the company does not receive a company-specific adjustment to the cost of capital. We have put forward evidence for why we consider it appropriate that we should be given a cost adjustment of 25bp to uplift the WACC to 3.45%, however this is not guaranteed and Ofwat has asked us to set out the risk management and mitigation we have identified should we not receive it.

Resilience performance commitments

***SES.LR.A1:** The company should ensure that its common and bespoke performance commitments associated with operational resilience are clearly defined, sufficiently demanding for AMP7 and the long term, and supported by the right incentives. We expect the company to satisfy the relevant actions set out in relation to the outcomes areas ensuring a line of sight between risks to resilience and package of outcomes.*

The theme of resilience was central to the development of our September 2018 Business Plan. In preparing our package of performance commitments we considered the resilience benefits they would bring and incentivised them appropriately based on customer views. Some, such as the common commitment focussed on risk of restrictions during severe drought and our bespoke commitment to reduce the risk of supply failures were designed specifically to measure the resilience of our service. Others primarily measure different aspects of service but achieving our target will deliver wider resilience benefits.

As described in the resilience chapter of our September 2018 Business Plan submission, we identified eight key areas of focus that reflected resilience in the round for our company and covered operational, financial and corporate resilience. In the development of these areas, we undertook an exercise to identify the primary risks associated with each of the eight resilience areas. This baselining work identified a wide range of resilience-related issues, which were then assessed on a gross (i.e. unmitigated), mitigated (i.e. with the current controls in place) and aspirational risk basis.

This helped inform the shape and scope of a wide range of work which we consider to be sufficiently demanding, that we propose to undertake during the period from 2020 to 2025 and led to the identification of the stretching performance commitments we have included. This was summarised in chapter 7 of our September 2018 Business Plan submission. We believe this work to enhance our resilience provides an appropriate balance of ensuring short-term improvements to resilience whilst also facilitating longer term customer and environmental benefits. One example of this is the approach to meet a proportion of our leakage reduction work through a leakage-focused mains replacement programme. Here, benefits will result within the next AMP, but will be sustained for multiple price review periods, and will spread costs over an extended period, thus providing a range of key customer and environmental benefits, improving long-term affordability and reducing the disruption of the intervention.

Demonstrating alignment between essential resilience areas, their associated key risks, our proposed interventions and stretching performance commitments is necessary to deliver a sustained, high quality supply and service to our customers today and in the future; and to give confidence that our plan will deliver resilience benefits. The following table shows how our performance commitments will contribute to increasing resilience by mapping them against our eight resilience areas, essentially providing the base 'line of sight' that will be developed over the coming months as part of our commitment to introduce a systems-based approach to resilience. Each of our 22 performance commitments has a direct link to increasing resilience. The incentives associated with these performance commitments are set out in the Delivering outcomes for customers chapter of this resubmission.

Resilience Category	Primary Risks	Performance Commitment(s)	2025 target
Customer Participation	Customer attitudes towards water efficiency & digital media and our overall ability to engage	• Per capita consumption • C-MeX • D-MeX • Supporting customers in financial hardship • Vulnerable support scheme awareness • Vulnerable support scheme helpfulness	• Reduce by 7.3% to 134l/p/d • Upper quartile performance • Upper quartile performance • 19,000 customers on water support • 68% awareness amongst customers • 80% consider scheme helpful
Sources and Process	Loss of strategic asset or assets through failure or security breach and impacts of climate change	• Risk of severe restrictions in a drought • Risk of supply failure • Unplanned outage at treatment works • Greenhouse gas emissions • Abstraction Incentive Mechanism	• No severe restrictions (1:200 drought) • 100% properties connected to > 1 works • Limit to no more than 2.3% • No more than 55kgCO_2e/Ml • Limit abstraction during water stress
Network Assets	Loss of strategic asset or assets through failure of security breach or extreme weather event	• Mains bursts • Supply interruptions • Leakage • Customer concerns about their water • Water quality compliance • Pollution incidents	• 57.2 bursts per 1,000km of mains • Less than 2.1min per customer/year • 15% reduction • 0.5 contacts per 1,000 customers/year • 0 on DWI CRI score • No category 1 or 2 incidents
People	Skills gap, age profile, pandemic or industrial action	No PC - details of activity included in People chapter of September 2018 Business Plan	
Supply Chain	Purchasing power, skills gap and financial downturn	No PC - details of activity included in Resilience chapter of September 2018 Business Plan	
Business Systems	Cyber attack and obsolescence (fitness for purpose)	• Void properties • First contact resolution • Priority services register	• No more than 2.2% unbilled properties • 85% resolved first time • 7% of customers on PSR, 90% data check
Financial	Gearing, efficiency challenge and financial downturn	No PC - details of activity included in Financeability chapter of September 2018 Business Plan	
Facilities Management	Loss or impairment of use or amenity	• Improving land diversity • Delivery of WINEP	• Biodiversity benchmark at three sites • Delivery of all 24 schemes

Resilience action plan

In our September 2018 submission we committed to progressing towards a more integrated risk management process, which would take place in the run-up to the 2020 to 2025 period. Ofwat has provided the following required action.

***SES.LR.A2:** The company should provide a commitment that it will, by 22 August 2019, prepare and provide to us an action plan to develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework.*

We commit to preparing and providing Ofwat with an action plan to develop and implement enhancements to our existing resilience approach as set out in the September PR19 Business Plan submission.

Our action plan will take account of Ofwat's feedback, consider best practice put forward by others in the industry and fully reflect the position of our business. It will be submitted by 22 August 2019, in-line with Ofwat's timescales, and will be provided in a form that makes it easy for others to track the progress of its implementation, use and impact.

It will build on the comprehensive risk baselining work previously conducted across the eight identified areas which highlighted over 100 resilience-related risks. It will introduce more explicitly the integrated resilience framework utilising a systems-based approach across the areas of operational, corporate and financial resilience and ensure that the interdependencies between systems are mapped and understood.

We will further prioritise the risks we face, through engagement with our customers and update the baseline assessment of our current level of resilience and identify our targets for the short, medium and long term.

This will ensure that the correct mitigations – across the 4Rs - are identified and where there are options we will discuss preferences with customers to ensure we co-create solutions and, where possible, increase customer participation in delivering resilient services.

This will allow us to embed a fully integrated approach to resilience throughout the 2020 to 2025 period, which is repeatable in the future and can adapt as new and different risks emerge.

It is our intention to work with independent experts, collaborate with others across the sector and engage key stakeholders to help us develop and implement our approach and we will conduct a third party review of our action plan to provide additional assurance that it is robust and will secure resilience for the long-term.

Asset health metrics

***SES.LR.A3:** The company should provide a commitment to work with the sector to develop robust forward-looking asset health metrics and provide greater transparency of how its asset health indicators influence its operational decision making.*

We consider our strong track record of delivery – which has been recognised by Ofwat – to be heavily influenced by our review and thorough ongoing assessment of the long-term health of our assets and, in turn, the operational decisions we make in the short- to medium-term. Clear examples of this can be demonstrated in the following areas:

- Our mix of raw water resources and their management has – comparative to others in the sector – made us more resilient to the short and medium-term impacts of climate change, evidenced via our ability to solely focus on demand-side options in our revised draft Water Resource Management Plan. This approach also provides a high degree of resilience to raw water quality issues through optionality in the choice of sources we use
- Early and sustained investment in our network – commencing with the split into district metered areas (DMAs) and the introduction of pressure management to better understand the drivers of leakage, bursts and supply interruptions and water quality concerns – all of which we consider as asset health indicators. This approach, along with higher than average levels of mains replacement activity, has resulted in our performance within these four areas now being upper quartile
- Our plan to roll-out intelligent DMAs in May 2019 – whereby we will install smarter sensors, meters, software and analytics to provide better oversight and predictions of network (and customer) behaviour. This will continue over the next price review period
- Timely and targeted capital interventions in our treatment works – which has built flexibility and reliability (two key asset health indicators) into our production operation, evidenced by our ability to rapidly increase output to meet demands (most recently seen in the 2018 freeze/thaw – with a 26% increase within a few hours) and continues to see our reactive maintenance activity hold at around 15% of total maintenance carried out. Over the forthcoming price review period, we will be enhancing our approach to maintenance by delivering a significantly higher proportion of our maintenance as condition-based rather than time-based, furthering our understanding of long-term asset health.

Since the sector received its feedback from Ofwat in January 2019, UK water industry research (UKWIR) have – on the understanding that the vast majority of companies received the same feedback – proposed a scope of works focused on two areas:

1. Provision of a suite of both lead and lag measures that can be used by the sector to improve their operational decision making and lead to more effective international benchmarking
2. To provide consistency in the way that the sector captures and collates a number of long-standing measures.

We have already indicated our intent to support and participate in this project, and therefore commit to work with the sector to develop robust and forward-looking asset health metrics and to help provide clearer line-of-sight between these metrics and operational decision making.

A copy of the current draft of UKWIR’s proposed project scope is included at Appendix A.LR1.

Financial resilience in the event of not receiving a company-specific cost of capital adjustment

SES.LR.A4: *Please explain the steps the company and its Board are taking to maintain long term financial resilience in the context that a company specific adjustment to the cost of capital is not guaranteed by the PR19 methodology (or at a future price control) and set out the risk management/mitigation approaches that have been identified.*

In the PR19 methodology Ofwat requested that companies demonstrate the financial resilience of their businesses, i.e. the extent to which the business's financial arrangements (actual and notional) enable it to avoid, cope with and recover from disruption, as part of their September 2018 Business Plan submission.

Ofwat required companies to demonstrate how financial resilience will be maintained over the 2020 to 2025 period, taking account of the overall assessment of risks faced by the company, including risks related to capital structure, and the impact of potential cost shocks arising from, for example, underperformance against our plan or from additional financial liabilities which are not funded by customers. Ofwat also requested companies to model a suite of downside scenarios it prescribed, as well as company-specific scenarios based on severe, reasonable and plausible scenarios for key variables to support their assessment, building on the long-term viability statements that are included in Annual Performance Reports.

In our September 2018 Business Plan submission we addressed these requirements by setting out our assessment of a range of risks, both prescribed by Ofwat and specific to our company. Under a number of scenarios, our assessment indicated that the stress tests would require additional borrowing.

We have already taken decisive action to increase our financial resilience. By the start of 2020 we will have reduced our level of gearing from 77% to circa 60%. Our increased level of equity means that we are in a strong position to raise finance if we need it. In addition, the Board has obtained a signed undertaking from our two main shareholders – and the intermediate holding company Boards – of their intent to provide financial support in the extreme scenarios described to ensure that we are able to continue financing our functions and deliver our commitments to customers.

On the basis of this assessment of potential calls on the headroom we have available within our plan, and the accompanying longer-term projections, together with the contingent support we have from our shareholders, we will be resilient on our planned capital structure (and by implication on the notional structure used for price setting purposes) through to 2030.

Elsewhere in our September 2018 Business Plan we explained that our efficient cost of capital is higher than the industry's (a point which Ofwat has not contested), and accordingly, we applied for a company-specific adjustment to the cost of debt of 25bps.

Ofwat's requirements for demonstrating financial resilience did not specifically include consideration of a scenario where a company-specific adjustment to the cost of capital proposed by a company was not allowed for at future price control periods. Moreover, given that the factors which give rise to the company-specific adjustment to the cost of capital that we have sought – a higher efficient cost of debt than the industry – is likely to persist into the future, we did not consider that it was likely we would not require such an adjustment to the cost of capital in future.

Linking the WACC with financial resilience

Ofwat's action suggests that their position is that a company should demonstrate that it is financially resilient in the long-term without any company-specific adjustment to the WACC, regardless of whether its efficient WACC is higher than the industry's efficient WACC, which, in turn, would indicate that it does not require an adjustment to the WACC in order to be financially resilient. In the event that a company indicated it does not need a company-specific adjustment to the WACC in order to achieve long-term financial resilience, Ofwat's approach would imply that the company-specific adjustment to the WACC would not be allowed regardless of whether that company's efficient WACC was higher than the industry's WACC.

Moreover, Ofwat's approach appears to suggest that the WACC could somehow be tailored to each company according to what is required to enable that company to be financially resilient in the long term, i.e. run a suite of downside scenarios and establish the minimum WACC that would be required to enable the company to be resilient in the circumstances covered by the suite of scenarios. This would likely to lead to different WACCs for every company in the industry, in contrast to Ofwat's approach in the past.

We also note that Ofwat has a duty to set, and companies are entitled to receive, an allowed WACC that reflects their efficient costs of finance. This is a well-established precedent, including from the CMA in the Bristol Water PR14 appeal.

Accordingly, we do not agree with the premise of Ofwat's question, as we do not see the link between the allowed WACC for a company and long-term financial resilience in this way. In our view, a company-specific adjustment to our allowed WACC will be justified for so long as our efficient WACC is higher than the industry's efficient WACC. In the event that Ofwat does not allow the company-specific adjustment, the Board will take the practical steps required to ensure the company remains financially resilient.

Future efficient cost of debt

The size of the required company-specific adjustment to the cost of capital is a function of not only differences in bond yields, but also differences in the mix of debt that we have access to. For example, because we raise debt less frequently and in smaller tranches, it may not be efficient for us to raise bond finance in all cases – sometimes bank debt will be more appropriate.

These factors can change over time. As such, it is difficult to forecast with absolute certainty how long our efficient cost of finance will remain above the industry's efficient WACC. It is possible that the company-specific adjustment to the WACC could decrease in the future, though it could also increase, depending on the size of the premium that we would have to pay to issue new debt over and above the cost of new debt for the wider water industry.

Noting the above, at this time we consider that we do not have sufficient information to enable us to forecast whether the company-specific adjustment to the cost of debt is likely to be higher or lower at PR24 and beyond, so we have assumed that it remains around the same size as it is now.

Commitment to efficient financing

As stated in our September 2018 Business Plan submission, EY was commissioned to assess the efficiency of our embedded debt at PR19, and concluded that there was no indication that our index-linked bond was inefficient, based on the evidence reviewed. Nevertheless, noting that our long-term financial resilience is also a function of our embedded debt costs, we are committed to taking whatever practical steps are available to reduce the cost of our existing debt and/or to otherwise improve the financial resilience of the company. Some of these risk management/mitigation steps include:

- Equity strengthening – our shareholders have agreed reduced dividends since 2015
- Reducing net debt by redeeming bank loans and reduced drawing on our existing RCF
- Ongoing review on financing options with respect to our long-term bond
- Attempts to renegotiate the sinking fund requirements related to our long-term bond
- Securing additional guarantees from our shareholders
- Removing high cost embedded debt
- Actions that have made our operations more resilient, so any major downside shocks have less impact on our business.

We are also committed to raising debt as efficiently as possible in future. We consider carefully any new debt which the business requires to ensure that it is the most appropriate financing solution instead of, for example, retained earnings or equity injections. And when we issue debt we also consider carefully, in consultation with financial advisers, the type of debt (bonds, private placements, loans, capex facilities etc), the tenor of debt (years to maturity and whether the debt is amortising or not), the currency the debt is issued in and whether the interest rate is fixed, variable and/or linked to inflation.

We consider that this represents an effective range of activities to ensure financial resilience of the business, but it does not negate the need for the allowed WACC to cover our efficient financing costs for the reasons outlined above. In the round, we consider it appropriate for a company-specific adjustment to the WACC to be applied at PR19 and we will revisit the size of any required adjustment for PR24 and each subsequent price control review taking into account the then-latest information available about market conditions and our own access to, and cost of, debt.

Further evidence on the company-specific adjustment we have proposed can be found in the Risk and return chapter of this resubmission.

CHAPTER 4

Targeted controls, markets and innovation

Targeted controls, markets and innovation

In its Final Methodology, Ofwat set separate price controls for the water resources, water network plus and retail areas of our business. It also promoted the use of markets to encourage greater efficiency and promote resilience. In its Initial Assessment of our plan, Ofwat identified one required action related to the promotion of markets - to revise our Bid Assessment Framework (BAF) to encourage third party delivery of our Water Resources Management Plan (WRMP) – which we confirm we will do.

Innovation was a key theme of the methodology and we demonstrated our ongoing commitment to innovation throughout our Business Plan with specific details within the Innovation chapter of our September 2018 submission. We have a clear vision for innovation – to constantly challenge ourselves to explore and implement new ways of working to deliver:

- Improved efficiency, effectiveness or resilience to our services
- Sustainable benefits over the longer term.

It is underpinned by four interconnected elements:

Culture	Strategy	Collaboration	Financing
supportive and empowering	prioritised, focused and one-step ahead	partnerships and openness	sufficient and sustainable

Our culture empowers our people to take forward ideas quickly through to implementation owing to our streamlined processes, appropriate incentives and company-wide collaboration. It is delivering results for both our customers and the environment – examples of which are detailed in this chapter and our original submission.

Ofwat identified an advised action related to our ongoing commitment to collaboration with other companies to maximise the opportunities for joint research. In addressing this action we provide further evidence of how our culture is focussed on promoting collaboration, not only with other companies but with a range of partners, and the role we play in bringing different parties together and maximising opportunities for the benefit of our customers and the environment.

In addition, we have chosen to include further information and evidence of our approach to considering Direct Procurement for Customers (DPC). Although not a required action we felt it was important that we are fully transparent about the decision making process we followed so have included detail within this resubmission.

Bid Assessment Framework

As part of our September 2018 Business Plan submission, we included a copy of our BAF dated August 2018, with the express intention of encouraging third party bids for all aspects of the delivery of our WRMP – specifically water resources, demand management and leakage reduction services.

In its Initial Assessment, Ofwat confirmed that we have produced a BAF for water resources generally in line with the principles of transparency, non-discrimination and proportionality. We received the following required action from Ofwat.

SES.CMI.A1: *The company should revise the bid assessment framework to address our concerns that the draft framework appears to discriminate in favour of the development and delivery of in-house solutions. The company should also provide more detail on the appeals process in the event of a dispute.*

We commit to fully reviewing our Bid Assessment Framework and revising it accordingly to ensure it addresses Ofwat's feedback. We will take the opportunity to further improve it so it aligns with industry best practice and provide information on the appeals process in the event of a dispute. We will re-publish it by 15 July 2019, in line with Ofwat's required timescales.

The current version of the BAF will continue to be considered as a live document and remain on the SES Water website until the revised BAF is published. We will notify Ofwat and key stakeholders when this takes place and highlight the changes made for ease of reference.

Collaboration with other companies

Within its methodology, Ofwat set a clear expectation that companies should collaborate closely in the development and delivery of key challenges facing the sector – including leakage and water efficiency.

In our September 2018 Business Plan submission, we detailed examples of how we are using collaboration to deliver better outcomes for customers, and particularly to drive innovation. We wanted to provide Ofwat with confidence that we are not only aligned with its expectation but are already undertaking activities to clearly demonstrate it. References and supporting case studies were included throughout our plan including in the Wholesale and Innovation chapters.

In its Initial Assessment of our September 2018 Business Plan, Ofwat confirmed that we recognise the importance of collaboration and provide evidence of collaborative work. However it highlighted that there was insufficient evidence of collaboration leading to innovation. The following advised action was given.

SES.CMI.BI: *The company should consider how it can collaborate with other companies to maximise the opportunities for research to address common challenges (e.g. leakage detection, water efficiency and wastewater treatment processes) rather than companies progressing research independently.*

We are committed to collaborating with other companies to share best practice, deepen our understanding of key issues and drive innovation with the aim of finding solutions to common challenges, improving the service we provide to customers and reducing our impact on the environment. As a small company we rely on collaboration to ensure that we can do this cost effectively and gain maximum benefits.

Collaboration is a key pillar of our innovation strategy and an area identified through the assessment we carried out to provide a baseline for our innovation maturity, enabling us to measure our progress as we continue to build the culture of innovation within our business. We believe we are one of the only companies that has assessed and benchmarked itself in this way.

We welcome the opportunity to address this action by elaborating further on our commitment to industry-wide collaboration, how we will maximise opportunities throughout AMP7 and beyond and how this is driving innovation, which benefits both our customers and those of the wider industry.

Collaborative platforms

We are an active member and participant in a number of industry bodies that provide a platform for collaboration across the sector. A number of these have been established for some time and have helped bring companies together to address common challenges and deliver industry-wide improvements. There is recognition by all involved that collaboration between companies can be increased and such bodies need to enable this by changing their strategic focus and showing industry leadership - bringing it together to address the big challenges, rather than responding individually to specific issues. There is also more work being undertaken with new partners to bring different experience and expertise into the sector. Below are some examples of how this area is evolving and our role within it.

Water Resources South East (WRSE): We are a member of WRSE, the regional group that has been established since 1996 to bring together the six water companies that operate across the south east to plan future water resources. We have committed to work through WRSE to develop a regional resilience plan to inform our next water resources management plan (WRMP) in 2024. The regional plan will step-up the current level of collaboration between the member companies to drive a common approach to demand forecasting, levels of service and resilience in the derivation of the plan as well as incorporating enhancements such as natural capital valuations and environmental net-gain into the options appraisal process. It will support the identification of the best value water resource options for customers, other water users and the environment, while supporting the growth of the region's economy. It also provides an opportunity for the companies to work together on the customer research to inform the plan, something which has been done almost completely in isolation until now, and gain a broader and more robust understanding of their views on levels of resilience and option preferences and how these change over time.

As part of its enhanced remit, WRSE has committed to providing a platform for collaboration and sharing of best practice to achieve the ambitious long-term targets the companies have committed to for water efficiency and leakage reduction. This work has started through an initial leakage sprint event and another for water efficiency is planned in early spring, which will develop into a programme of activity to support advancements in these areas, alongside other key partners.

WRSE will also play an important role in stimulating the market to put forward new ideas and innovations to tackle these important issues, as well as the identification of potential new water resource options through the BAF.

UKWIR: We, like the rest of the industry, fund the common water industry research programme run by UKWIR. UKWIR is changing its strategic direction to focus more on the long-term challenges faced by the industry, which it has set out through its "Big Questions" programme. UKWIR is uniquely placed, not only because all the UK water companies are members and contribute to its funding, but also as it can access a wide range of expert partners and alternative funding streams to optimise the delivery and outcomes of research undertaken. We are actively involved in UKWIR's programmes – being the only current water-only company to have a member of staff involved as a programme lead – and are committed to supporting it to deliver collaborative, independent and high quality research that provides evidence to drive the sector forward and stimulate innovation.

Water UK: From Board representation at Managing Director level, our involvement with our trade body is significant. In addition to many of the strategic debates taking place – including learnings from the freeze/thaw in March 2018 and preparations for a no-deal Brexit, we play a key role in a number of specific technical forums including active leakage control, pressure management and the development of asset health metrics.

On water efficiency, Water UK is managing a project '*Pathways to PCC Reduction'* to identify ways to significantly reduce Per Capita Consumption (PCC) in the long term. We are on the steering group for this project. We also benefit from being in the Water Efficiency Network (WEN) hosted by Water UK, which has representatives from most water companies. Members of this group contribute to a collaborative fund managed by a steering group (which we are a member of). A range of projects have been commissioned, supported by the fund, including on shower consumption, leaking toilets and, more recently, the benefits of water efficiency labelling of water-using fittings.

The Drinking Water and Strategic Water Quality networks provide the opportunity to meet with colleagues from the water quality community. It enables the sharing of ideas and the comparison of performance data. Importantly, when there have been serious water quality events, such as our major chemical incident (at Elmer treatment works in Feb 2017), the Drinking Water Inspectorate have required that the learnings from these events are shared industry-wide. Therefore, these forums provide the ideal opportunity to disseminate information to the wider industry about serious incidents to minimise the risk of reoccurrence, with the aim of lowering future Event Risk Index (ERI) and Compliance Risk Index (CRI) scores across the sector. Sharing of best practice and industry learning ultimately leads to better water quality for all customers.

Academia: We recognise the innovative, ground breaking work being undertaken in a number of the UK's universities to address water-related challenges. From the Twenty65 programme at Sheffield University that is aiming to generate sustainable and tailored water solutions; to the MARIUS project at Oxford exploring the management of future drought risk, there is a plethora of research and expertise for us and the rest of the sector to access and be involved in. We are committed to exploring with our sector colleagues how best we can collaborate with these institutions so that the industry can capitalise on what they can offer for the benefit of all our customers. In some cases this may be best achieved through established bodies such as UKWIR, in others there may be more direct mechanisms for collaboration. To help guide our decision making about where we invest our money and resources we intend to establish a research collaboration framework that we can apply to help us get involved in the right projects at the right level for the benefit of our customers.

Think tanks and business groups: Interest in the water sector continues to grow and a number of organisations are increasing their focus on water-related issues and offer platforms for collaboration, the exploration of new approaches and to share ideas and best practice. We have closely followed the work carried out by Sustainability First's new Energy and Water Public Interest Network, not least because of its focus on strong governance, a priority area for us. Likewise, we have become members of Business in the Community (BITC) to help advance our community credentials and tap into their ambitious water taskforce. As a small company, we need to be strategic about where we invest time and money in such groups. We will continue to work with our peers who face similar challenges to maximise our combined involvement in programmes that have common benefits as efficiently as possible.

Collaboration with the supply chain

In addition to collaborating with other water companies – either directly or via industry bodies - we also view the opportunities within the supply chain as a vital collaboration tool, particularly due to the fact that many of our partners are engaging with multiple companies across the sector.

We publish details on our website of not only the innovation projects we are working on, but also set out the key challenges we face and where we believe we will require innovative solutions to address them. This has been welcomed by the supply chain and is driving them to contact us to offer potential solutions that we can assess as part of our embedded process to identify and progress where appropriate.

For example, in working with our networks term services provider, we are in the process of transitioning, ahead of March 2020, to first time reinstatement on all reactive job types – an activity that happens to varying degrees elsewhere within their portfolio. We are also working with the same partner to gain vital insight into the learnings associated with fulfilling a compulsory metering programme, which we plan to start from April 2020.

In addition, we have engaged our recently appointed mechanical and electrical framework delivery partner on a specific cost challenge for our resilience main installations. The provision of a standby pumping station was proving challenging – both from a cost and local stakeholder perspective. Through collaborative engagement with our partner, an alternative, skid-mounted mobile unit was built off-site at significantly lower cost, and without impact on local businesses and customers.

Innovation via collaboration

A further core area of collaboration is via our well established innovation process.

We have an active and visible innovation lead and an established, beneficial innovation process. We are committed to sharing our learnings as well as the outcomes of our innovation programme with industry colleagues and others and are regularly invited to present at a range of national and international conferences and technology showcase events, including most recently at the WWT Innovation Conference and the World Water Tech event in Toronto. In addition, we host design sprints which we invite fellow companies to join, and encourage our staff to take part in design sprints and hackathons run by other companies to actively contribute to sector-wide innovation advancement.

In our September 2018 Business Plan submission, we stated that innovation can take a number of forms – from the incremental (i.e. an existing idea or practice which is new to SES Water) to the radical (i.e. a new idea that is yet to be used anywhere in the sector – or wider), and our innovation lead's remit is to scan horizons to identify such opportunities. This allows us to bring new ideas into the business to test, and we commit to sharing our successes (and failures) with those outside. We have a dedicated innovation budget which is typically used to fund projects to proof of concept phase – after which we rely heavily on identifying potential partners to assist in further development and scaling – ensuring we achieve value for money.

Our small size and stable and reliable network means that we are an attractive partner to companies who are often in the very early stages of development of a solution or who are looking to conduct low-cost trials. This enables us to minimise our costs as suppliers are looking to gain valuable experience and are willing to waive development costs. Our early adoption and development of the Google Maps co-ordinate remote working solution is an example of where we were able to roll out an innovative solution at a low cost.

However, typically we find that while we are able to assist in the early development of a product, our size and level of resource, limits our ability to scale it. We therefore actively seek partners, such as larger water companies, to participate in the ongoing development of solutions so that their benefits can be realised. This was evidenced in the recent development of the Waterfall smart water hub, a collaboration between ourselves, Creative EC (an agile development company) and the insurance industry, to allow consumers to see and understand real time water use as well as protecting against internal bursts and subsequent water damage. Having funded and assisted the development of prototype units and conducted early trials, we held a joint event in London to share the findings and collaborate in the development of this device. Ten water companies attended and contributed to the discussion, which led to a number of other pilots being commissioned.

We have carried out a similar collaboration in the development of Meter Shield, a device which allows full water flow to newly built properties for testing purposes, whilst restricting the volume to prevent potential water damage and unauthorised use. Whilst we funded and carried out the initial development work with Flostem, we have shared the test data and physical devices we commissioned with a number of other water companies, in order to assist in the further development and wider adoption of the device.

In summary

We are and continue to be committed to collaboration with our sector colleagues and wider stakeholders. It is an essential part of our vision for innovation – to continue to challenge ourselves to explore and implement new ways of working to deliver improved efficiency, effectiveness and resilience of our services and deliver sustainable benefits over the long-term. This will ensure we provide customers with great service and good value for money. As we embark on AMP7 we commit to influencing and maximising the outputs of the existing forums we are involved with and strategically choosing the collaborative projects we engage in.

As a comparatively small organisation, our twin objectives of sharing with and learning from, others across the sector require careful consideration, but it's essential that both happen equally. With human and financial resources in short supply, we choose the initiatives we support carefully. As a result, we believe that we do more than just ‘pull our weight’ at a sector-level.

Critical for us and our sector colleagues will be our ability to apply the outputs of research and implement learnings from shared best practice swiftly and effectively. We must ensure there is a clear line of sight from the research outputs to improvements to our business so we can demonstrate to our customers and stakeholders the innovation that is being driven through such projects and the benefits it brings to their service. This is essential to build trust and confidence in our company and the sector more broadly and we are committed to achieving it.

Direct Procurement for Customers (DPC)

We have taken the opportunity within this resubmission to provide evidence to support the approach we took to considering the opportunities for DPC in the delivery of our Business Plan for 2020 to 2025.

As part of its Water 2020 programme, Ofwat set out its initial proposals with regards to DPC, expanding on these in various publications thereafter, including in June 2018 when it provided clarity on its expectations regarding the provision of high-quality and well-evidenced cases for DPC within water companies’ PR19 Business Plans.

Projects that would be deemed suitable for DPC would be valued in excess of £100m on a whole-life totex basis, and comprise the design, build, financing, operation and maintenance of enhancement infrastructure projects.

During the course of the next Price Review period, the total capital investment programme we propose is costed at £126m. Within this the largest enhancement projects are as follows:

a. Bough Beech Treatment Works extension (phase 3): A £5.6m project (of which £3.1m is classified at enhancement) to complete the scope of works conducted on a multi-AMP basis to increase the capacity of the works from 50Ml/d to 70Ml/d
b. A £3.5m programme of works to upgrade four treated water pumping stations to increase their capacity.

Both of the above schemes form part of our resilience work to ensure all customers can be supplied by more than one treatment works by 2025. As such, under normal operation, the additional capacity created will not be in daily use (being only called upon in the event of an extended treatment works outage). As such, the operational expenditure associated with these schemes will be minimal, and hence the total expenditure of these schemes will not be materially greater than the capital costs set out above. In addition, both schemes form part of existing assets that provide a daily operational function.

We do not believe that any of our projects proposed for the 2020 to 2025 period meet the criteria for DPC for the following reasons:

- Their whole-life totex will be less than £5m
- The schemes are for resilience purposes, and as such, whilst providing an essential function, will be called upon for use less than 1% of the time

- The schemes are upgrades to existing operational assets and are therefore not 'discrete' in their operation or maintenance.

As a result of the combined points set out above, we do not believe these schemes will be attractive to potential investors and we do not consider any schemes within our AMP7 programme meet the criteria of DPC. We have therefore elected not include any DPC schemes within our Business Plan for 2020 to 2025.

CHAPTER 5

Cost efficiency

Securing cost efficiency

In our September 2018 Business Plan we committed to delivering a range of service improvements against five pledges at a fair price accepted by our customers. The total expenditure requested to deliver our plan was £286 million. In it, we committed to making £21 million of efficiency savings between 2020 and 2025. Our plan proposed increasing investment in our services to £126 million – more than £400 per household – with an average bill of £207 (including inflation).

In its Initial Assessment of our plan, Ofwat assessed our expenditure requirements to be inefficient based on the results of its cost efficiency modelling work and considers that we have fallen short of high quality in this area. At a company level, Ofwat's assessment is that our expenditure requirements are around 18% above its view of efficient costs. Our wholesale business expenditure requirements have been assessed as being 16% above its view of efficient and our retail requirements as being 34% above its view of efficient expenditure.

Part of Ofwat's approach has been to disallow all expenditure in some areas, such as to provide the level of leakage reductions supported by our customers and to deliver the environmental requirements of the Water Industry National Environment Programme (WINEP). For a range of areas where customers have told us they want us to improve services (known as 'enhancement expenditure') Ofwat has assessed our expenditure requirements as efficient and in some cases the least cost approach put forward by all water companies.

In our Business Plan we made one request for additional expenditure (a cost adjustment claim) due to the unique statutory obligation we have to soften a proportion of the water we supply to our customers. The need for additional expenditure was fully accepted by Ofwat but 82% of the required expenditure has not been allowed due to the approach Ofwat has taken to model the expenditure requirements.

We do not support Ofwat's approach to cost assessment in a number of areas. In this chapter and associated appendices we provide additional evidence to support the expenditure requirements included in our plan. In particular we provide evidence that:

- Ofwat disallowing enhancement expenditure to reduce leakage is not justified and is not in customers' interests
- Our approach to leakage reduction activity will deliver longer-term benefits to resilience and therefore the additional cost is appropriate
- The econometric models fail to appropriately reflect uncontrollable items that impact companies' costs, such as electricity consumption requirements and regional labour
- Our requested funding to meet our statutory obligation to soften water has not been funded despite Ofwat accepting the need for investment
- The forecasts for key metrics such as future customer numbers that Ofwat has created are not based on the justified evidence put forward in our plan
- Ofwat's own econometric models suggest that it is setting unachievable cost reductions across the industry.

Ofwat has identified one required action related to the costs of delivering our plan:

SES.CE.A1: *We provide our view of efficient costs for the company along with our reasoning. We expect it to address areas of inefficiency, or lack of evidence, in the revised business plan. Where appropriate, we expect it to withdraw investment proposals if either:*

- *the need for investment is not compelling; or*
- *there is no need for a cost adjustment claim beyond our existing cost baseline.*

We describe how we have addressed this action in section one of this chapter.

Ofwat has also identified a second action related to expenditure to tackle metaldehyde in our water sources:

SES.CE.A2: *There may be significant impacts in terms of investment or type of investment as a result of the metaldehyde ban. The company should investigate and agree with the DWI the scale and timing of any potential changes compared to its submitted plans. Significant changes and uncertainty may require an outcome delivery incentive to protect customers in the instance of expenditure not being required. Should the company propose a performance commitment and outcome delivery incentive, the company should provide evidence to justify the level of the performance commitment and the outcome delivery incentive rates proposed, in line with our Final Methodology. We expect to receive evidence of customer support for outperformance payments, where proposed, and that the incentive rates proposed are reflective of customer valuations*

We respond to this action in section two of this chapter.

Section 1: Delivering our plan – expenditure requirements

We have updated our expenditure requirements to take account of the latest information we have. The changes to the overall expenditure requirements are not significant as we remain of the view that our September 2018 Business Plan included the efficient costs needed to continue to deliver a high quality service to our customers and to enhance services in areas that matter most to them. We have not withdrawn any of our expenditure proposals because service improvements, with associated additional expenditure requirements, were supported by our customers and stakeholders. The cost adjustment claim we made to allow us to meet our statutory requirement to soften water was also accepted by Ofwat although only a proportion of the expenditure has been allowed. It remains part of our plan and we provide additional information to support its inclusion in full.

We reiterate that the bill impact resulting from our proposed expenditure was viewed as acceptable when tested with customers. In its Initial Assessment, Ofwat also supported the planned bill changes proposed in our plan which are a direct result of the expenditure requirements we put forward. Ofwat also supported our targeted performance levels for the majority of the performance commitments we proposed.

The change in customers' bills from 2020 onwards remains broadly in line with our original plan. This was the bill level accepted by our customers. This is despite the bill increase generated from the HMRC tax changes which we have absorbed through movement in other opening adjustments and from some additional efficiencies we have made to our planned expenditure. Our executive summary provides further information about the bill profile from 2020 to 2025.

We will continue to seek ways of delivering our commitments more efficiently between now and 2025. Any resulting cost savings will, as they are now, be shared with customers through the relevant mechanisms in the regulatory framework. However, we have found that Ofwat has not adequately justified the efficiency assumptions it has applied both to wholesale and retail expenditure.

This section focuses on the issues we have found with Ofwat's approach to cost assessment in a number of areas. We find it concerning that Ofwat's approach can show that we have provided efficient expenditure proposals for the majority of service enhancements but for base costs we are subject to an 11% efficiency challenge. The same principle to forecasting costs has been applied to all areas of proposed expenditure. We applied a bottom-up approach by assessing the current cost to deliver and applying expected efficiencies that can be delivered over time. This approach, and the efficiencies assumed, were described in our September 2018 Business Plan. Given the same approach was taken to deriving all expenditure forecasts we found the results of Ofwat's modelling approach surprising.

Ofwat's efficiency challenge also includes the removal of all costs for certain activities. Most materially it has excluded £17.4m for the activity required to meet our customers' and stakeholders' expectations to reduce leakage. Without this expenditure we will only be able to deliver our commitment to reduce leakage by significantly reducing our activity in other areas which will cause both short and long-term service deterioration.

Updated expenditure forecasts

We have revised our expenditure forecasts for 2018/19 and 2019/20 to reflect the likely outturn position for the current year and the budget for 2019/20 agreed by our Board in February 2019.

For 2020 to 2025 we have re-evaluated the expenditure requirements and planned efficiencies and found minimal scope to reduce expenditure. We consider that significant risk will be placed on deliverability of the plan supported by our customers if expenditure is reduced. As noted above, and explained in our September 2018 Business Plan, we consider that our current costs are efficient and we have factored future efficiencies into our forecast costs.

For the wholesale business we have reduced totex (excluding grants and contributions) by £0.4m. The expenditure profile remains in line with our September 2018 Business Plan.

Figure 1: Wholesale totex (excluding costs recovered through charges for third party services and grants and contributions)

For the retail business we have reduced operating expenditure by £1.3m by re-evaluating the efficiencies that will be delivered as a result of our new digitalisation strategy now that we have progressed into the delivery stage. Overall costs have increased by £0.3m due to a £1.6m increase in depreciation which reflects the now fully known costs of our new systems that are being installed in 2019/20 as part of our important Customer Experience Transformation (CET) programme described in our September 2018 Business Plan. The operating and capital expenditure to deliver the CET this year and next is being fully funded by shareholders as the activity was not planned or costed when the current allowed cost to serve was set.

Figure 2: Retail costs

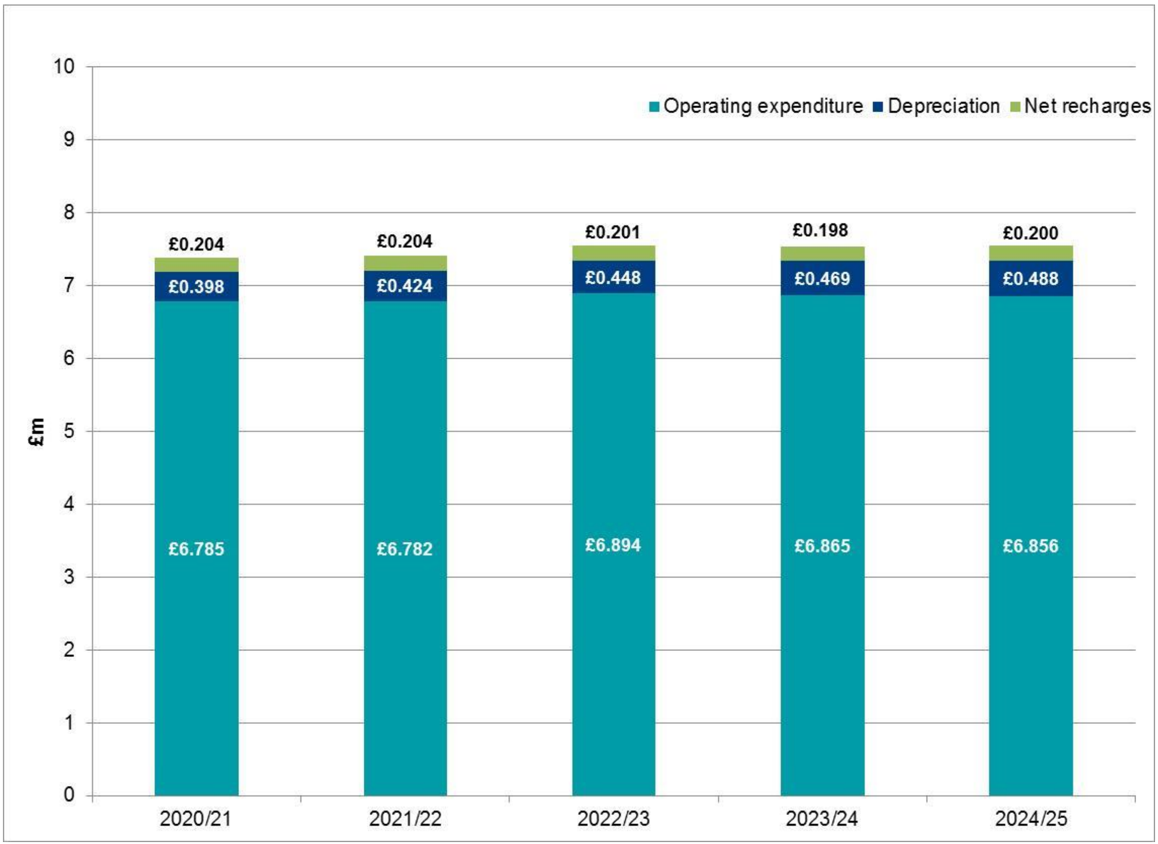


Figure 2 shows that our retail costs are relatively stable over the period despite our expectation that we will provide services to around 5% more customers by the end of 2024/25, including significant growth in metered customers who are more costly to serve; and increasing our activity to support our customers, particularly those in financial hardship.

Wholesale base expenditure modelling

To set base expenditure allowances – which cover operating expenditure and capital maintenance expenditure – Ofwat has developed five econometric models. These models aim to predict what historical expenditure from 2011/12 to 2017/18 would have been based on a set of cost drivers. Each model is used to set a modelled cost allowance for 2020/21 to 2024/25. A final modelled allowance is set by triangulating the results of the five models. In doing this Ofwat is acknowledging that there is no perfect model and that there is therefore a degree of error and bias in all models. To calculate the final allowance Ofwat has provided in its Initial Assessment the following adjustments have been made to the results of the modelling:

- A 4.8% reduction is applied to all companies to represent catch-up efficiency
- A 1.5% per annum reduction is applied to all companies as Ofwat's assumption for frontier shift, which should account for the net effect of future cost changes in relation to CPIH that are beyond the control of management and the ongoing efficiency improvements even the company which is currently most efficient should make over the period

- Adding back in company-specific costs that were excluded from the modelling (business rates, abstraction charges, traffic management act costs) and costs recovered through non-water charges (third party costs).

In carrying out each step above Ofwat has made a choice as there are different approaches that could have been taken. In our view Ofwat has not explained each of these choices adequately to allow us to understand its rationale. We are therefore providing evidence on the choices we consider are most robust and ask Ofwat to consider our points and respond to each when finalising its approach in setting base expenditure allowances in the Draft Determination.

Our areas of concern are summarised in the following table and explained below.

Area	Summary of concerns with approach
Dependent variable	Ofwat has made an error in continuing to include capex related to softening while stating that softening related expenditure is excluded.
Cost drivers	Some of Ofwat's models fail to pick up uncontrollable differences in companies' characteristics that impact on relative costs. The reasons for choosing some variables used is unclear. In applying its own forecasts Ofwat has not explained why it considers its forecasts to be more robust than companies' forecasts.
Catch-up efficiency	Ofwat has not explained why it has calculated the assumption using five years of data when it models a seven year period.
Frontier shift	Ofwat has not adequately justified why it has not accounted for any impact of real price effects in its assumption, nor why it considers that water companies can significantly outperform comparator sectors in terms of productivity improvements.
Unmodelled expenditure	Ofwat has incorrectly applied an efficiency assumption to traffic management costs.

Choice of dependent variable

We recommend that Ofwat excludes capex related to softening activity from its models as well as opex to meet the intent stated in its Initial Assessment. The data required to do this is available in Table Wn6 of the Business Plan Data Tables.

Since the Initial Assessment we have queried the reasons for the exclusion and it appears to have been due to a simple error in what data has been used. Ofwat also noted in responding to our query that it may change its position given that some of its models include treatment complexity variables and therefore there is potentially no need to assess softening related expenditure separately. We disagree with this position because the complexity of treatment at each of the five water treatment works that include assets required for the softening process does not change if the softening process is excluded from the assessment of treatment process complexity. The treatment complexity variable therefore takes no account of the additional complexity and related cost of delivering softened water.

Further information to support this position is included below in our discussion of the wholesale softening expenditure modelling.

Choice of cost drivers

Ofwat has noted that it has aimed to produce models that are "sensibly simple". We agree that this is the right approach to take. However, we are concerned that for the Initial Assessment it has resulted in some of the models being used to set expenditure allowances failing to pick up material differences in costs between companies that are not simply due to inefficiencies, but instead relate to uncontrollable impacts on relative costs. We appreciate that there is no perfect model and that, through our own testing and our understanding of Ofwat's approach to cost assessment over the last few years, cost drivers that may be expected to be statistically significant are not. There are a number of reasons why this may be the case but which would not preclude them from being important information to include in assessing relative efficiency. For example the lack of year-on-year variability in the data meaning that they are not strong drivers of models where year-on-year variability is mostly being driven by where companies are on their capital investment cycle; or, the issues of companies taking different approaches in collecting and reporting data. We have therefore looked at alternative approaches to explain material differences in expenditure and propose one additional cost adjustment claim for the electricity costs in base expenditure which we explain later in this section.

Scale variables

The two chosen scale variables used in Ofwat's models – total connected properties at year end and length of mains – produce coefficients that are reasonable. Ofwat has used two total wholesale models and in each the scale variable used is total connected properties at year end. If, as we understand it, Ofwat's intention of triangulating the results of different models is to counteract the bias in each model then we consider that it would be reasonable to include length of mains as the scale variable in at least one of the two wholesale water models. This is on the basis that close to 60% of wholesale water expenditure relates to treated water distribution and therefore we see more reason for including this scale variable than the current one used.

Asset related variables

To a degree there is an engineering choice between inclusion of a booster pumping station or a service reservoir/water tower on the network, as they are all assets needed to ensure adequate supplies to our customers. We therefore consider that a variable that includes all these assets makes more engineering sense than the current variable that covers only booster pumping stations.

Exclusion of uncontrollable cost drivers

We have previously suggested to Ofwat, based on our own analysis and reflecting on the Competition and Markets Authority's feedback in the Bristol Water PR14 redetermination, that average pumping head is a sensible variable for inclusion in wholesale water models as it should represent the different power requirements of companies as a result of both the geography of the area and type of sources used to abstract water.

Power is a significant proportion of costs for all water companies. While the unit cost is, to a degree, within management control, the volume required is less controllable. As a company that abstracts most of its water from boreholes (which requires pumping water from deep underground) and operates in an area bisected by hills, we consider that a proxy for the additional electricity required must be a necessary component of the cost assessment approach in order to reflect differences between companies' electricity consumption that are outside of their control.

We note Ofwat's statement that average pumping head was tested as a variable in the models but it was not statistically significant, and acknowledge that we have found a similar issue across the majority of models tested. We have previously raised concerns with the comparability of data across companies and remain concerned that this is the reason why it cannot be robustly included in the models.

In the absence of a robust approach to modelling what we consider to be a key cost driver we have developed a cost adjustment claim related to electricity consumption and the consequences it has on the cost of supplying water. This is included in Appendix A.CE1 and relevant data has been included in Tables Wr8 and Wn6 of the Business Plan Data Tables. In this claim we provide evidence that our electricity unit costs are efficient. We have taken action to reduce consumption where we can but our consumption remains higher than the average due to factors outside of our control. We are therefore requesting an ex-post modelling adjustment of £10.5m.

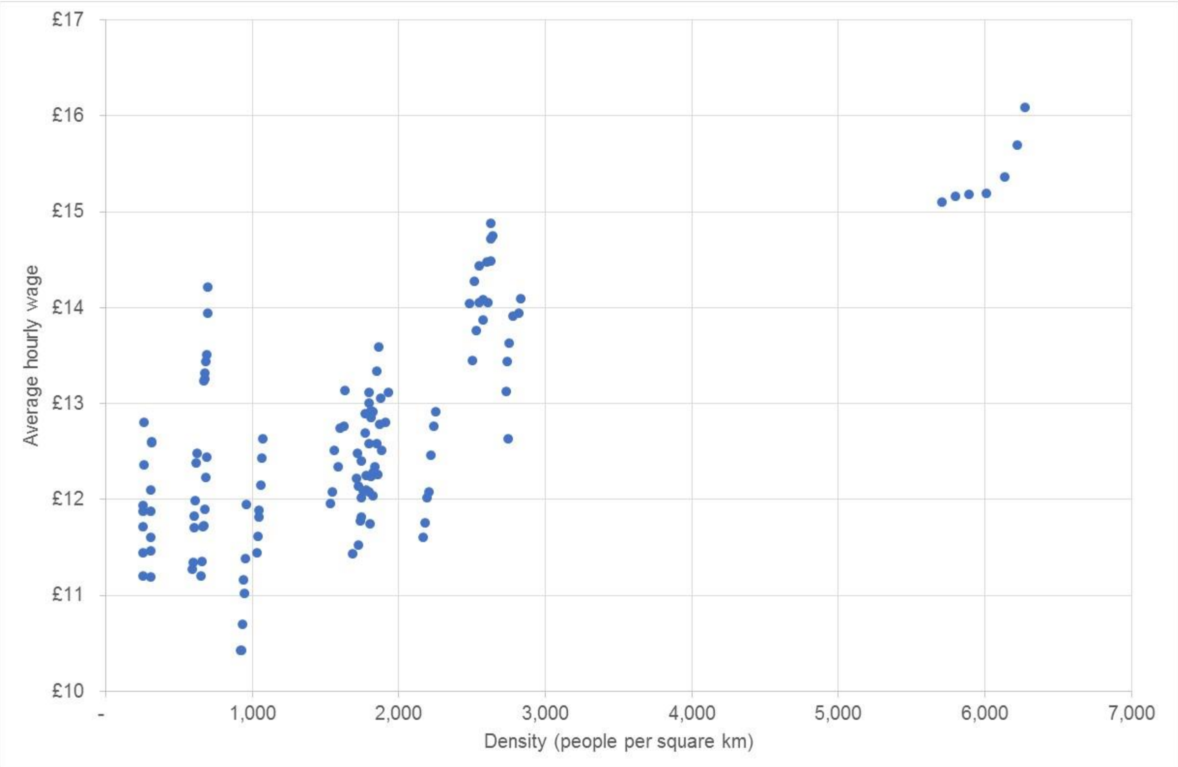
Regional labour

There is robust and independent evidence that costs of employment vary across the country for reasons that are beyond management control. For example, ONS data from the Annual Survey of Hours and Earnings 2018 shows that average wages in the region where we are based are 20% higher than those in the region that South West Water operates in and around 8% higher than the average for England and Wales. Labour represents around 43% of our wholesale expenditure forecast for 2020/21 to 2024/25 and the vast majority of the workforce needed to deliver wholesale services is required to be situated in the area we operate in. Assuming, as Ofwat's approach to modelling does, that our labour costs are the same as the industry average would imply our totex allowances would be 4% lower than they should be to adequately address this area of uncontrollable cost differences. We conclude that Ofwat's approach does not currently provide for this material difference in companies costs that should be allowed for.

Ofwat has found that it is not possible to include a statistically valid relevant cost driver in any of its models. This is not surprising given the lack of variation in regional wages both over time and across most water company regions. However, this does not negate the fact that it is a material contributor to the difference in costs between companies as represented above. We are therefore proposing that an ex-ante adjustment is made to the output of the models to account for this uncontrollable variation in cost. We also considered proposing a cost adjustment claim but ruled this out on the basis that such a claim would be asymmetric, i.e. if accepted it would result in a positive adjustment to our efficient costs, whereas the approach we are proposing can be used to make a symmetrical adjustment across companies.

As part of its explanation for not factoring in regional wages in setting cost allowances, Ofwat's Initial Assessment notes that the inclusion of a density variable (and its squared term) capture the effect of regional wage as it is correlated with regional labour. We have reviewed the correlation and do not find the relationship to be as suggested. In Figure 3 we show ONS data on regional wages plotted against regional density as calculated by Ofwat. The correlation appears to be driven by the London area. Therefore, while Thames Water has both the highest density and wages, this relationship is substantially less clear for other companies. We therefore consider that a post-modelling adjustment is required to address differences in regional labour across companies and note that Ofwat has already developed an approach to doing this that builds on the approach used by other regulators.

Figure 2: Relationship between regional density and wages



Ofwat has previously, through the development of its approach to cost assessment, considered the inclusion of a regional labour cost differential in its approach. Ofgem has also previously included an adjustment to account for regional labour cost differences. We are requesting that Ofwat apply the ex-ante adjustment approach it has previously considered to account for differences in costs across regions. Specifically we are proposing that Ofwat:

- Use ONS data to construct an index of relative labour costs across companies (noting that Ofwat has already shared a working version of the construction of such an index with companies)

- Use this index and information on the proportion of costs that relate to labour to adjust companies' historical expenditure prior to modelling so that this element of uncontrollable difference in costs is removed prior to the assessment of relative efficiencies
- Reverse this adjustment by adding (or subtracting) expenditure from the results of the model based on relative costs of labour across companies.

Ofwat's cost driver forecasts

We disagree with the changes Ofwat has made to the drivers of companies' costs that are used to set cost allowances. This has a material, detrimental impact on our cost allowance and Ofwat has not adequately demonstrated why its forecasts are more robust than our own. We agree that Ofwat cannot simply use companies' forecasts but consider that Ofwat should assess the robustness of the forecasts provided in determining whether each company's forecasts are reasonable or whether it has to divert to using its own forecasts and explain the reasons for doing so.

We also note that in taking the approach it has, Ofwat has introduced inconsistencies in the values calculated both across different parts of the business and in how average bills are represented which should be addressed in the Draft Determination or there is a risk of Ofwat quoting figures that are not robust. For example, the number of properties has been adjusted in the determination of efficient wholesale expenditure but the same adjustment has not been made to the representation of efficient retail expenditure and neither has Ofwat used its view of the number of properties we will serve in recalculating the resulting average bill.

Generally, Ofwat has relied on time trends or historical averages which do not take into account the expected changes in circumstances in which we operate. In particular it ignores the expected population growth in the south east of England widely documented, including by Ofwat.

Table 1 shows the variance between our forecasts and Ofwat's and the resulting £3.1m reduction in totex allowances. We discuss in turn each of the cost driver forecasts and repeat the evidence submitted in our September 2018 Business Plan to demonstrate the robustness of these forecasts.

Table 1: Cost driver forecasts, average 2020/21 to 2024/25

Cost driver	Submitted	Ofwat view	% change	Impact
Connected properties at year end (nr)	303,438	299,668	-1.2%	-£1.3m
Length of mains (km)	3,530	3,523	-0.2%	-£0.1m
% of water treated at complexity level 3-6	100%	100%	-	-
Weighted average treatment complexity (index)	5.1	5.1	-	-
Booster pumps per km	0.010	0.009	-2.8%	-£1.7m
Weighted average density	NA	2,780	NA	-
Total				**-£3.1m**

Connected properties

Ofwat's forecast is based on the trend experienced between 2011/12 and 2017/18. This fails to adequately take into account the predicted growth in customer numbers as presented in our revised draft Water Resources Management Plan published on 3 September 2018. We engaged Experian to provide the forecast and the increase in annual growth rates is based on local development plans. Further information can be found in our revised draft Water Resources Management Plan and in particular Appendix E1.[1]

Length of mains

Ofwat's forecast is based on the trend experienced between 2011/12 and 2017/18. This fails to adequately take into account two factors:

- the expected growth in housing in our area as forecast in detail in the revised draft Water Resources Management Plan published on 3 September 2018
- the programme of mains extensions to deliver our resilience performance commitment to allow water to be supplied to all customers from more than one treatment works.

To reflect these two impacts our own forecast should therefore be used rather than Ofwat's.

Volume of water treated and complexity of treatment

While there is no impact on us in moving from using our own forecast to using Ofwat's there is an impact for other companies. Ofwat's approach of using a time trend to forecast volume of water treated fails to take into account the significant demand reduction activity forecast by companies. Even when taking into account population growth we, like the majority of companies, are forecasting a reduction in the volume of water we treat. Ofwat's time trend approach therefore assumes a higher volume of water treated for all except two companies.

Volume of water treated at works with complexity rating 3 to 6 is forecast independently, also based on a time trend, and therefore creates forecasts for some companies that are materially different to their own.

Booster pumping stations per km of main

Ofwat's forecast is based on the average number of booster pumping stations between 2015/16 and 2017/8. This fails to take into account the increase by one booster pumping station that we are planning to use from 2019/20. This addition is integral to us realising the resilience benefits of one of the new mains being installed under our resilience programme to deliver our performance commitment to allow water to be supplied to all customers from more than one treatment works. Without this pumping station the performance commitment cannot be met and therefore it should be included in the forecast as base operating cost will increase as a result of this additional asset. Our own forecast should therefore be used rather than Ofwat's.

[1] Revised draft Water Resources Management Plan, September 2018

Application of catch-up efficiency assumption

In the section above we have explained the factors that we consider need to be accounted for to reduce the gap between Ofwat's view of our efficient costs and our view. This may impact on the catch-up efficiency assumption applied to all companies.

We have not seen any evidence from Ofwat on why it chose to set the sector catch-up efficiency assumption using only five years when the models are all built using data from the past seven years. We consider that a longer time series is favourable as it will help smooth out any perceived efficiencies that actually relate to the different timing of investments between companies. We request that Ofwat appropriately evidences the reason for its approach or changes it.

Frontier shift

While elements of Ofwat's approach are reasonable and follow regulatory precedent we are concerned by the lack of justification for not including an assumption for real price effects (RPEs) and for the inclusion of additional efficiency improvements due to the totex and outcomes frameworks.

We find that there is a lack of robust evidence to support Ofwat's conclusions that:

- CPIH will capture industry input price inflation and therefore an adjustment for RPEs is not required. We provided evidence to the contrary in our September 2018 Business Plan (see the Business Plan Data Table Commentary for Table App24a)
- There is scope for additional productivity improvements in addition to productivity growth that may be expected from the water industry based on analysis of historical productivity in comparable sectors.

We support the conclusions of First Economics in its paper of March 2019[2] and ask Ofwat to review the evidence it has used to establish the frontier shift assumption and revise the assumption to be based on robust evidence.

Changes to unmodelled expenditure forecasts

Ofwat has applied an efficiency challenge to the expenditure we requested to meet legislation associated with the Traffic Management Act (TMA). We consider that it is incorrect to expect us to reduce the requested expenditure in this area through efficiencies because the expenditure included is to cover the cost of the charges set by local authorities for permits and lane rental charges and therefore outside of our control. In our stated expenditure requirement in this area we did not include the ongoing management and inefficiencies to working practices that are created from TMA related legislation. It is unclear whether other companies did as there was no definition included to guide companies in what costs to include. If we had then an efficiency adjustment may be appropriate to ensure ongoing improvements in the management of working practices.

Wholesale softening expenditure modelling

In our September 2018 Business Plan we made one request for assessment of expenditure separately from the base cost modelling approach, reflecting our statutory obligation to soften water which makes us unique in the industry.

[2] First Economics: A review of Ofwat's PR19 approach to estimating frontier shift, March 2019

Ofwat accepted the need for investment to meet our softening requirements and the detailed explanation we provided in support of the required expenditure of £12.1m from 2020/21 to 2024/25. However, it excluded £9.9m from its assessment of the additional expenditure required on the basis that its base cost modelling approach provided an allowance that also covered a proportion of the additional costs we face in softening water. We disagree with the position Ofwat has taken.

Ofwat explained that it reached its position because the relevant base cost models include a treatment complexity variable. Ofwat's position will however only hold true if removing the assets and processes used to soften water results in a reduction in the treatment complexity at any of the five sites where the softening process occurs. This is not the case. In Table 2 below we provide information on each of the sites where water is softened and list the processes and the resulting treatment complexity for each of these sites (excluding the softening process). In bold are the treatment processes that lead to the complexity grading. The treatment complexity variable therefore takes no account of the additional complexity and related cost of delivering softened water. Ofwat's statement that the treatment complexity variables in its models therefore allow, in part, for the additional costs of softening is therefore incorrect.

Table 2: Treatment works with softening – processes and complexity grading

Treatment works	Treatment processes	Treatment complexity grading
Woodmansterne	Super-chlorination Aeration Flocculation Coagulation Rapid gravity filtration **Granular activated carbon (GAC) (for pesticide removal)** Orthophosphoric acid dosing Chlorination, contact and de-chlorination Ammoniation	GW4
Elmer	Super-chlorination Aeration Flocculation Coagulation Rapid gravity filtration **UV treatment** Orthophosphoric acid dosing Chlorination, contact and de-chlorination Ammoniation	GW4
Cheam	Aeration pH correction Rapid gravity filtration **GAC (for pesticide removal)**	GW4

	Orthophosphoric acid dosing Chlorination, contact and de-chlorination Ammoniation	
Godstone	**Super-chlorination** Aeration (for iron removal) **Flocculation** **Coagulation** Rapid gravity filtration Orthophosphoric acid dosing Chlorination, contact and de-chlorination Ammoniation	GW3
Kenley	Super-chlorination Aeration Flocculation Coagulation Rapid gravity filtration **GAC (for pesticide removal)** Orthophosphoric acid dosing Chlorination, contact and de-chlorination Ammoniation	GW4

We are therefore resubmitting our original cost adjustment claim. In Appendix A.CE2 we provide further evidence in support of our cost adjustment claim for softening costs as a result of feedback received in the Initial Assessment.

Wholesale enhancement expenditure modelling

Enhancement expenditure represents around 25% of our forecast totex. This is one of the lower funding proposals in the industry. We have targeted enhancement expenditure in areas supported by our customers and stakeholders and consider that all expenditure requested is necessary to deliver the commitments and pledges we have made in our plan.

Ofwat has taken various approaches to assessing the efficiency of different areas of expenditure proposals including econometric modelling and engineering assessments. In general, Ofwat has found our proposals appropriate and our cost of delivery efficient. In Table 3 we summarise the enhancement expenditure in our plan.

Table 3: Enhancement expenditure in our Business Plan resubmission

Area	Opex (£m)	Capex (£m)	Totex (£m)
Lead standards	-	1.720	1.720
New developments	8.447	9.380	17.827
Resilience	-	8.866	8.866
Metering	1.440	19.661	21.101
Leakage reduction	2.491	14.951	17.442
Water efficiency support	2.589	-	2.589
WINEP	1.413	-	1.413

We find that in some areas Ofwat has not explained how it has reached its conclusion on the enhancement expenditure it proposes to allow. In each of these cases we provide further evidence on the forecasts put forward and ask Ofwat to consider our points and respond to each when finalising its approach in setting enhancement expenditure allowances in the Draft Determination.

Our areas of concern are summarised in the following table and explained below. We have also reflected on how we treated new development and connection related costs in the data tables and provide information on this below.

Area	Summary of concerns with approach
Leakage reduction	Ofwat has excluded all leakage reduction enhancement expenditure as it considers that reductions should be paid for through base expenditure allowances.
WINEP	Ofwat has excluded c. £1m of opex related to delivering WINEP and not adequately justified why. It has also reallocated the remaining WINEP opex to capex.

Funding leakage reductions

Ofwat has not allowed the enhancement expenditure requested by half of the companies for achieving the leakage reduction targets set out in their Business Plans. We are one of those companies.

Disallowing expenditure to deliver enhanced levels of service

Ofwat has asserted that we should fund leakage reduction through our base cost allowances. Ofwat's proposed funding approach for leakage reduction will not result in regulated revenues sufficient for us to finance the efficient costs of meeting the leakage reduction target in our plan. We, alongside other water companies, commissioned NERA Economic Consulting to evaluate the approach taken and propose alternative approaches that Ofwat should take to ensuring that an appropriate level of funding is provided to deliver our performance commitment in this area. The report is provided in Appendix A.CE3 and the findings are summarised below.

Ofwat's statement that base allowances can be used to fund leakage reductions is only correct if certain assumptions hold true in the approach it has taken to set base expenditure allowances. NERA's report provides evidence that these assumptions are highly unlikely to be true and we summarise the key points as follows:

- By definition the historical expenditure that Ofwat has modelled to set base allowances excludes expenditure to deliver enhanced levels of service
- Base cost assessment models do not include leakage reductions as a cost driver and therefore fail to pick up differences in historical costs due to delivery of different levels of performance across the industry
- Base cost assessment models, at best, capture the costs needed to deliver the historical level of leakage reductions which were significantly lower than those proposed by the industry for the period 2020/21 to 2024/25.

NERA's report provides options that Ofwat can take forward in revising its approach to ensure that companies can fund the leakage reductions supported by customers and stakeholders. We ask that Ofwat applies an alternative approach that provides efficient costs to deliver enhanced levels of service as we consider that the current approach taken is not justified.

Unit cost of delivering leakage reductions

NERA's report also examines the approach Ofwat has taken to set the unit cost of reducing leakage and raises the following concerns with the approach:

- The marginal cost of leakage reductions rises as companies reduce leakage to lower levels because more costly options are required as you move further away from the sustainable economic level of leakage (SELL) and we therefore consider that it is not appropriate to set an industry wide unit cost assumption
- Unit costs derived by Ofwat combine both individual company unit costs and also their out and underperformance ODI rates. As the ODI rates capture marginal benefits as well as marginal costs, and are scaled by a 50% sharing factor we consider that there is no logical justification for including ODI rates in the calculation of a unit cost.

We support NERA's conclusions and ask that Ofwat apply a more logical approach to setting an efficient unit cost for delivering our enhanced service in relation to leakage reductions that draws on the analysis NERA has completed.

We note that Ofwat's current calculation of unit cost takes into account only the costs submitted as enhancement expenditure. There is a further £16.5m in our base operating expenditure to maintain the level of leakage we will have achieved by 31 March 2019. This may also be the case in relation to how other companies have separately costed maintenance of current levels of service and enhancement to service. Both base and enhancement expenditure is needed to deliver the reductions committed to in our plan.

The unit cost calculation Ofwat has done is conceptually correct (except for the issues listed above) if the unit cost is being used only to calculate a unit cost for enhancement as is currently the case. However, it further emphasises the concerns raised above and articulated in NERA's report about Ofwat's approach to setting base cost allowances where no account is taken of the different levels of service, and resulting different marginal costs, planned to be delivered by companies.

We note that our unit cost of leakage reduction activity calculated by Ofwat by dividing the planned enhancement expenditure by the Ml/d reduction that is being targeted shows that our unit cost is the highest in the industry. This is due to the strategy we outlined in our September 2018 Business Plan to take a multi-faceted approach to leakage reduction through active leakage control activity, pressure management and mains replacement.

In considering the best overall option for our customers, we assessed the requirement to strike the right balance between cost and benefit to customers both in the short- and long-term. We have considered the different levers available to reduce leakage and targeted an appropriate mix based on: relative cost of options; sustainability of options and the long-term benefits they bring not just the short-term impact on leakage; and minimising risk that could come from too great a reliance on one or two approaches.

The final point is a practical concern for us. We are already achieving an upper quartile leakage level and as such consider that the 'low-hanging fruit' to allow us to meet our target has already been picked and therefore, all else held equal, it is more expensive for us to deliver the committed reductions than a company not currently one of the best performers in the industry.

Table 4 shows that if we excluded the reductions being delivered and the associated expenditure, our unit cost is consistent with the industry average. We note that to continue to deliver the planned reduction the unit cost would be higher than presented in the "removing mains replacement" option in the table because the marginal cost of the remaining options increases as the required level of activity increases.

Table 4: Unit costs of leakage reduction approaches

Area	Enhancement totex (£m)	Reduction delivered (Ml/d)	Unit cost (£m/ml/d)
Planned approach	£17.443	3.60	4.85
Removing mains replacement	£4.352	2.40	1.81
Industry median calculated by Ofwat			2.07

We therefore emphasis the message in our September 2018 submission that this multi-faceted approach will help us to deliver leakage reductions in the most efficient and sustainable way for the long-term and maintain a focus on the resilience of our network. That is why we are targeting delivering of a third of the reduction through mains replacement – the most expensive option in the short-term.

We have provided our reasoned arguments why Ofwat should change its approach to funding enhancement expenditure to reduce leakage which is backed up by analysis from NERA. On the basis that a revised approach from Ofwat will, in some form or another, still require a unit cost to be derived we have taken the decision to include in this resubmission an additional cost adjustment claim to cover the additional unit cost that will allow us to deliver our planned leakage strategy. This strategy has benefits both in the short term by providing a sustainable approach to leakage which reduces the risk of not delivering our committed performance level; as well as delivering long-term benefits to the resilience of our network. We are seeking an ex-post cost adjustment of £13.1m for wholesale network plus. Further details are provided in Appendix A.CE4.

Meeting the WINEP requirements

The current version of the Water Industry National Environment Programme (WINEP) requires us to deliver 24 investigations, plans, catchment management schemes and improvement measures. In our plan we allocated the enhancement opex required to deliver these improvements to the current level of service under three areas – invasive non-native species, Water Framework Directive (WFD) measures and catchment management schemes. Ofwat has not assessed our request for funding for the first two items on the basis that we requested opex, which it infers is covered by base cost allowances as previous expenditure was within the modelled historical costs. For the third area it has allowed expenditure but states that it is being treated as capex rather than opex because "evidence in the Business Plan documents identifies that, in part, the work addresses Raw Water Deterioration in Drinking Water Protected Areas while also delivering investigations - both activities where the one-off costs are conventionally treated as capex"[3]. We do not agree with Ofwat's interpretation of our plan and we address each area of expenditure below.

Invasive non-native species

We confirm that these costs will be new from 2020/21, i.e. they have not been incurred in the past and therefore will not be part of the historical costs used to set base cost allowances, and they are opex in nature.

The expenditure is largely based on utilising external resource (to support internal resource) to assist with habitat and ecological surveys, weed management, treatment and control and development and delivery of training. Successful completion will also include the completion of risk assessments, investigations, options appraisals, liaison with recreational users of Bough Beech and toolbox talk delivery. All components are therefore operational expenditure, since no physical assets will be purchased under the costs proposed.

WFD measures

These costs will be new from 2020/21, i.e. they have not been incurred in the past and therefore will not be part of the historical costs used to set base cost allowances, and they are opex in nature.

The planned enhancement expenditure in this area is working with partner organisations on river restoration measures, such as weir removal, that will enhance the River Wandle as a habitat and improve its ecology. This is an operational cost because the physical assets involved will not be owned by us.

The expenditure on internal resourcing for investigatory work and other support is not included in the request for enhancement expenditure because it will be recovered through base cost allowances.

Catchment management schemes

These costs are opex in nature as they relate to provision of resources and no physical assets will be purchased. Expenditure is required to deliver 13 water quality investigations or catchment schemes:

- five are quality investigations, focusing on ensuring we have fully characterised the relevant catchment areas in order to identify any action that may be needed to prevent any potential deterioration in surface or ground water quality
- eight quality catchment schemes are to be completed to reduce seasonal and long-term trends in nitrates and solvents.

[3] Ofwat's wholesale water enhancement feeder model: freeform, January 2019

Expenditure to address catchment-related improvements linked to metaldehyde that was in our plan has been removed. This is explained in section 2 of this chapter.

Supporting housing growth
When completing our September 2018 Business Plan we found issues in reflecting the operational expenditure for connecting new properties to the network. We found that, despite these costs being recoverable from customers through developer services charges (grants and contributions), they were impacting on the water charges due to the workings of the data tables and financial model. In the latest data tables required from Ofwat there is increased granularity on which we can provide information on the grants and contributions. We have therefore reflected all connections related expenditure across the relevant tables – App28, WS1, WS2, WS8 and Wn3.

In our previous submission we did not include the opex related to new housing growth in table WS2 as enhancement expenditure. This information was provided to Ofwat following a query after the submission. The expenditure in Table 3 above is now included.

Retail cost modelling

To set retail cost allowances – which cover operating expenditure and depreciation – Ofwat has developed nine econometric models. These models aim to predict what historical costs from 2013/14 to 2017/18 would have been, based on a set of cost drivers. Each model is used to set a modelled cost allowance for 2020/21 to 2024/25. Ofwat's final modelled allowance is set by triangulating the results of the nine models. In doing this Ofwat is acknowledging that there is no perfect model and that there is therefore a degree of error and bias in all models. To calculate the final cost allowance Ofwat has provided in its Initial Assessment a 26% reduction is applied to all companies to represent catch-up efficiency.

Area	Summary of concerns with approach
Approach to modelling	Ofwat's models produce a wide variation in results and the modelling suggests that the majority of companies should have higher costs than requested.
Cost drivers	Some of Ofwat's models fail to pick up uncontrollable differences in company's characteristics that impact on relative costs. In applying its own forecasts Ofwat has not explained why it considers its forecasts to be more robust than companies' forecasts.
Catch-up efficiency	Ofwat's models suggest that the cost reductions proposed by some companies are not achievable based on its set of cost drivers yet it has decided to apply the future upper quartile savings to all companies.

Robustness of modelling approach
The results of Ofwat's models show the instability inherent in them. The variability in the results of the four top-down models suggests the models do not give a precise overall

picture of cost drivers. We are therefore concerned that there are limitations to taking an econometric approach to assessing efficient retail costs.

Overall the forecast industry costs are 20% lower than the allowances provided from the modelling. This indicates that the models are either poor predicators of future costs or companies' forecasts are materially understated. This second point we address in more detail in relation to the concerns we have on how the catch-up efficiency adjustment has been created.

On the first point, Ofwat should consider returning to setting allowances based on a cost to serve approach in its Draft Determination or consider using a mix of econometric modelling and cost to serve for different areas of cost. The cost to serve needs to take in to account to reflect:

- the proportional differences in metered customers between companies on the basis that it is more expensive to serve metered customers
- the different points that companies are in their investment cycles and the consequences this has on depreciation that is recovered through cost allowances
- the economies of scope available to water and wastewater companies in providing customers with joint bills.

Choice of cost drivers

If Ofwat continues to take an econometric modelling approach to setting cost allowances it should consider whether the dual service connections cost driver is robust based on the feedback we provide below. Similar to our arguments for wholesale, we also consider that a regional labour adjustment is required for delivery of our retail plan and provide our reasoning below.

Dual service connections

It is surprising that this cost driver is in the two 'other retail costs' model but has not been used in any of the four 'total retail costs' models given that 'other retail costs' are the most material part of total costs. We propose that Ofwat considers whether this cost driver should be included in any models.

Regional labour

There is robust and independent evidence that costs of employment vary across the country for reasons that are beyond management control. Labour represents around 57% of our retail operating expenditure forecast for 2020/21 to 2024/25. Ofwat has previously stated that retail services can be delivered outside of the area and therefore it is a management choice where to locate. Separately locating retail and wholesale businesses raises some practical issues for a small company such as us. For example, a proportion of the senior management team has responsibility for both wholesale and retail aspects of the business. Most importantly though, an approach that would see our customer services team located outside our supply area is not supported by our customers.

We have consistently heard through our engagement that customers value being served by a local company and this means our employees need to be based in the local area. The four main reasons given were:

- Better customer service: “A modern service which is easy to understand”
- Having local knowledge: “It’s easier to deal with someone that has local knowledge of the area”
- Easier/quicker communication: “They are able to respond quickly to issues that matter to me”
- Provide jobs for the local community: “Local supplier employing local people”.

We also tested our customers’ willingness to pay for a local customer contact centre and the results show resounding support for this (see appendix A1.3 of our September 2018 Business Pan).

In our discussion above on wholesale base expenditure modelling we provide a practical solution for addressing the current missing cost driver in Ofwat’s modelling approach. This solution could equally apply to retail cost modelling if Ofwat continues to use an econometric modelling approach. If it moves to a cost to serve approach a regional labour adjustment could still be applied symmetrically by accounting for the proportion of the retail cost to serve driven by labour and applying a positive adjustment to companies who operate in areas with higher than average labour costs and a negative adjustment to those companies that operate in areas with lower than average labour costs.

Ofwat’s cost driver forecasts

Proportion of metered customers

We have found that Ofwat has used out-of-date information to calculate the proportion of metered customers rather than using the information submitted in our September 2018 Business Plan Data Tables. We request that Ofwat uses the information from our data tables to calculate this cost driver. The data aligns with our revised draft WRMP as published in September 2018.

Transience

Ofwat has stated that high transience rates can result in reduced ability for companies to recover unpaid bills and consequently higher bad debt and debt management costs. The coefficient for this cost driver, which is included in one of the nine models used, is however the wrong sign. We suggest that Ofwat either derives models where the impact of the variable is as intended or removes this variable from the model in question.

Application of catch-up efficiency assumption

Ofwat has reduced the cost allowances derived from its models by 26% for each company. It calculates this reduction by taking the upper quartile ratio between companies forecast costs in their Business Plan and the results of Ofwat’s models. All bar two companies are forecasting costs that are lower than predicted by Ofwat’s models.

We are seriously concerned about the validity of the cost savings proposed by companies given that Ofwat's cost models provide materially greater allowances. A review of companies' proposed savings shows that:

- There is a lack of evidence around how some retail costs will be reduced, raising questions over their credibility
- Evidence that historical cost reductions have resulted in decreased customer satisfaction and that subsequent spending to solve these issues is likely to mean the full cost reduction is infeasible
- Large reductions can reflect overspending in PR14 (which are reflected in Ofwat's cost models), which may be easier to remove than new cost reductions and therefore only possible for companies with previous overspends.

We consider that further evidence needs to be gathered on the deliverability of the cost savings proposed by companies in assessing the risks around assuming the industry as a whole can deliver the savings being proposed.

In our September 2018 Business Plan we described the activity currently in progress as part of our Customer Experience Transformation programme. This is being delivered to both improve service and to deliver future efficiencies, some of which will take time to materialise. Our plan commits to delivering around a 6% reduction in operating expenditure over the five-year period. Our strategy to do this is focused on further optimising our digital services and moving more customers onto online channels, increasing first-time resolution of issues through effective account management and supporting the fast-paced change to metered billing. We have confidence that our targeted efficiencies are achievable and sustainable. They will be delivered through:

- The new billing and customer relationship management system that will be in place by 2020 which will automate more complex customer journeys and give us improved functionality to manage contact levels by channel and help with resource planning
- The new online platform, which again will be in place by 2020, will allow customers to self-serve reducing the contacts we receive
- Further deployment of our target operating model will ensure we are appropriately resourced across all customer activities within retail, retaining a lean workforce capable of servicing our customers to a high standard.

If the Initial Assessment cost reductions – which we consider have not been robustly quantified for the reasons stated above – are applied it materially risks delivery of the high-quality service our customers expect.

Section 2: Addressing uncertainty related to the ban on metaldehyde

We are in the process of agreeing a new Undertaking for metaldehyde with the Drinking Water Inspectorate (DWI). This will take into account the impact of the planned ban on metaldehyde. A draft proposal was submitted to the DWI on 31 March 2019. The only significant adjustment to our planned expenditure in AMP7 as a consequence of the metaldehyde ban is the elimination of costs to support farmers in purchasing the more expensive substitution products (ferric phosphate). We have therefore reduced our operating expenditure by £0.066m over the period 2020 to 2025. All other costs required for catchment management and the treatment of water remain necessary to continue to achieve the water quality standards because of the remaining challenges from other pesticides and nutrients.

We consider that a performance commitment and associated financial incentive is not therefore necessary because we have removed the costs associated with addressing the water quality challenges from metaldehyde. We will bear any risk if the metaldehyde ban does not go ahead and we are required to reintroduce mitigations.

CHAPTER 6

Risk and return

Risk and return

Our September 2018 Business Plan submission included a package of incentives that aligned our company and investor interests with those of our customers.

As a small, local company, we face a higher cost of debt and to address this we included a 25bps uplift to the weighted average cost of capital (WACC). Ofwat challenged this approach and asked us to provide evidence for why this proposal was justified. We maintain that it is justified and have provided further evidence against Ofwat's three tests to demonstrate this, in addition to the evidence provided in the Cost efficiency chapter that our costs are appropriate and efficient for a company of our size.

In our September submission we presented our return on regulated equity (RoRE) analysis for the 2020 to 2025 period. In light of Ofwat's feedback we have reviewed our overall assessment of RoRE which has resulted in a more symmetrical RoRE range, although certain downside skewing remains, which is explained by the risks that remain primarily from a financing and cost perspective for our business.

We have also removed the uncertainty mechanisms associated with business rates and lead that were included in our original submission.

Our September 2018 Business Plan submission provided detail on the financeability of our plan and our financial resilience through to 2030. In it we tested financeability on our actual structure and noted that the plan was also financeable on Ofwat's notional structure given that the former was a more stringent test, primarily because the notional structure adopts interest rates materially lower than the interest rates actually payable on our historic borrowings.

In this resubmission we have demonstrated that our plan is in line with the ratios required by the ratings agencies for our target credit rating against Ofwat's notional structure as well as our actual structure. We have also confirmed in this submission that the headroom (in the form of additional borrowing capacity) available to ensure long-term financeability under the notional structure would be even greater than the headroom under our actual structure.

We have restated the assurance provided by the Board in this area and have produced an updated Board assurance statement that addresses financial resilience as part of the Confidence and assurance chapter.

Below we address the required actions identified by Ofwat in relation to aligning risk and return.

SES.RR.A1: *The company should remove the requested company specific adjustment from its plan and associated financial modelling or provide compelling evidence following the three-stage approach set out in the PR19 methodology if it continues to request a company specific adjustment.*

In our September 2018 Business Plan submission, we adopted the indicative guidance on the Weighted Average Cost of Capital (WACC) issued by Ofwat as part of the PR19 methodology, with the inclusion of a company-specific adjustment for the cost of debt of 25 bps. This increased our wholesale WACC to 3.45% for 2020 to 2025, resulting in an extra £1.75 on the average annual bill.

An explanation for why the cost of debt is higher for us than the larger companies can be found on page 127 of our September 2018 Business Plan submission.

In this resubmission of our Business Plan, we maintain that this uplift to the WACC is required and justified to address the unavoidable costs that we incur in raising debt financing due to our relatively small size and the infrequency with which we raise substantive debt. Below we have provided further evidence for this approach in line with Ofwat's three stage approach, as set out in the PR19 methodology.

Our response to this action is linked to our response to action SES.LR.A4 which can be found in the Securing long-term resilience chapter of our resubmission.

Test area one – customer support

In our September 2018 submission we presented evidence of customer support for a company-specific adjustment to the WACC. Independent research conducted to inform the development of our plan showed that 82% of customers were willing to pay an additional £4 per year to be served by a small company.

In its Initial Assessment of our plan, Ofwat took the view that we had provided insufficient evidence of customer support for the adjustment. In particular they highlighted that we polled a small sample size (100 people) and that we tested views on a £4 per year uplift, which was based on the existing difference between the average sector water bill of £178 per year and our equivalent of £182 per year, rather than specifically measuring the customer support for the additional £1.75.

In response we commissioned a further piece of independent research which was conducted in March 2019 by Explain Market Research. It tested the views of 539 customers through a combination of hall test and online survey methods. This time we specifically asked customers about whether they were willing to pay an extra £1.75 to be served by a small, local company.

The research showed that 86% of respondents supported paying £1.75 per year extra to be served by a small, local company and this was consistent across all socio-economic groups. As in our original PR19 research, customers identified the role small companies play in the local community, support for local jobs, high quality service and local knowledge as key positive attributes of their service. Similarly, the negative factors identified included higher costs, less investment and financial stability. Combined with the research we carried out at PR14, it demonstrates that customers' views on being provided services by a small, local company have remained consistent over time and that they are prepared to pay more for this service. There is more information in Appendix A.RR1 and A.RR2.

Together, we consider we have provided compelling evidence of customer support for the uplift of 25bp that we have included in our submission.

Our Customer Scrutiny Panel (CSP) has reviewed both pieces of research conducted on the company-specific adjustment and supports our approach.

Test area two – customer benefit

Ofwat's second test area considers the benefit that being served by a small, local company brings, not just to the customers of the company, but to customers in general across the country, on both cost and service benchmarks.

In our September 2018 submission we referenced the findings of an independent study by EY to establish the practical as well as theoretical evidence that smaller companies deliver benefits to society in general through characteristics and actions that arise from the distinctive characteristics of small companies. The report describes four hypotheses about the advantages that being small and local might give rise to:

1. Small local firms have agile decision-making structures
2. Small local firms are better at innovation
3. Small local firms are more consumer orientated
4. Customers prefer products and services from a local company

In this resubmission we provide further evidence of examples of how our small size is leading to benefits for all water customers.

- Our small size meant we were one of the first water companies to bring in a social tariff and it was fully rolled out within a year. This has led to us significantly exceeding our target for the number of customers who are on the scheme during this five-year period. This makes us the third best performing company, behind only Dwy Cymru and Affinity Water, according to CCWater research (Water for All: Affordability and Vulnerability in the water sector 2017-18) with 294.13 customers per 10,000 registered for the social tariff in 2017/18. This is upper quartile performance and driving the wider industry to higher levels of social tariff penetration over the 2020 to 2025 period and ensuring that more customers who are in financial hardship are getting the support they need
- During the March 2018 freeze/thaw event only four of our customers experienced loss of supply for longer than 12 hours due to our detailed operational knowledge, short chains of command and rapid executive decision making. The subsequent review carried out by Ofwat identified a number of areas of focus so companies improve their response to future incidents. Our strong performance has provided a high service standard that others are now required to achieve, which will benefit all customers through improved management of such events
- We have consistently been one of the best performing companies for supply interruptions – a high priority area for customers. Our current performance level of 3.14 minutes per household has enabled Ofwat to set a high upper quartile performance level for all companies for 2020 to 2025 of three minutes. This will drive significant improvements to the service provided to all customers from the current average performance of 22 minutes lost per household

- Our leakage level is one of the lowest in the industry at 83 litres per property per day compared to an industry average of 123 litres per property per day. We have consistently met our targets for nineteen years and have committed to a further 15% reduction by 2025. Achieving this will see our leakage level fall to 70.55 litres per property per day, making us one of the industry's top performers and setting the standard for other companies which will make service for all customers more resilient in the long-term.

Test area three – level of adjustment

As described in our September 2018 submission, we decided the size of the adjustment proposed by considering two key factors:

- Recent regulatory precedent – 25bps was the allowance on the cost of debt granted to some water companies in their PR14 Final Determinations
- Overall pressure on affordability – we tested our business plan incorporating a 25bps uplift to the cost of debt with our customers who supported our proposals.

We therefore included a 25bps uplift on the cost of debt in our WACC to enable us to deliver their priorities. In its Initial Assessment, Ofwat confirmed that this was within the plausible range.

In summary, we believe that we have proposed an appropriate level of uplift which is affordable for our customers, the additional funding is driving benefits for all consumers in some of the most critical areas of performance and our customers support paying £1.75 extra to be served by us. Taken together we believe this provides convincing evidence for the 25bps uplift to the WACC we have proposed in our business plan. In addition, our view that our costs are appropriate and efficient for our company circumstances, as set out in our Cost efficiency chapter, complement this company-specific adjustment.

SES.RR.A2: *The company should provide a clear statement from the Board that the business plan is financeable on both the notional and its actual company structures.*

A compliant Board statement is included in the Confidence and assurance chapter.

SES.RR.A3*: The company should set out the steps taken and the assurance obtained by the board in order to assess financeability of the business plan.*

This is covered in the above Board statement.

SES.RR.A4*: The company should provide further evidence that all of the financial ratios are consistent with the target credit rating on the notional structure.*

As can be seen in our response to action SES.RR.A5, all our financial ratios are consistent with the target credit rating for our actual financial structure. This is what the rating agencies will rate us against so we are confident that our credit rating will not change.

For the purposes of this resubmission, we have presented our financial ratios under Ofwat's notional structure, which are also consistent with the target credit rating ratios and can be seen in the table below.

Credit Ratios	Baa Criteria	2020-21	2021-22	2022-23	2023-24	2024-25
Adjusted Interest Coverage Ratio	>1.5	1.68	1.66	1.61	1.72	1.83
Gearing	<70%	60.3%	60.7%	60.7%	59.7%	58.2%

SES.RR.A5: *The company should provide further evidence that the company is financeable on its actual structure, in particular in relation to its ability to maintain financial ratios in line with its debt covenants given the limited headroom set out in the plan.*

In its Initial Assessment of our plan, Ofwat highlights that we state that we will comply with bond covenants through to 2030 and that we set out the key financial ratios in relation to our covenants, which includes an interest cover ratio that has no headroom to the threshold. They have asked us to provide further evidence that we can maintain our financial ratios at the level required to ensure they remain in line with our debt covenants, given the limited headroom set out in the plan.

To test the financeability of our September 2018 Business Plan submission, we forecast key financial ratios used by the credit ratings agencies on both a notional and an actual balance sheet basis. We also tested whether our projected financial ratios were consistent with the covenants on our £100m index-linked bond, which we took out in 2001 and is expected to redeem in 2031. The financial ratios used in the covenant tests are different to those used by the credit ratings agencies.

There are three kinds of bond ratios within bond covenants:

- **ICR (Interest Coverage Ratio) –** required to be above 1.3, cash interest payment divided by cash inflow within last 12 months
- **AICR (Adjusted Interest Coverage Ratio) -** required to be above 1.0, (cash interest payment + bond indexation) divided by cash inflow within last 12 months
- **RAR (Regulatory Asset Ratio) –** required to be below 80%, net indebtedness divided by RCV.

The projected financial ratios used in the covenant tests that were shown in the PR19 Business Plan are reproduced in the table below.

Bond Covenants	Criteria	2020-21	2021-22	2022-23	2023-24	2024-25
Interest Cover Ratio (ICR)	>1.3	1.90	1.88	1.88	1.87	1.88
Adjusted Interest Cover Ratio (AICR)	>1.0	1.00	1.01	1.01	1.00	1.00
Regulatory Asset Ratio (RAR)	<80%	72.5%	74.0%	74.7%	74.7%	74.6%

Source: SES Water business plan data tables (April 2019) App10

Due to our financial structure, AICR has always been the tightest bond ratio. In our September 2018 Business Plan, our AICR remains just above 1.0 throughout AMP7, but it can be recovered by additional borrowing to increase cash inflow, which subsequently increases RAR.

Since AICR is controllable through additional borrowing, the key metrics to assess our financial resilience would be RAR, representing how much 'headroom' we have to additionally borrow cash to recover AICR, in the case of any downside scenarios in our cash flow. Importantly, in our PR19 Business Plan submission, the minimum amount of 'headroom' in each year of AMP7 will be c.£17m.

As we stated in our original submission, because we are complying with the covenant ratios we will have sufficient headroom on the Ofwat and credit rating's ratios. We also stated that there is £24m of additional borrowing capacity up to the threshold of 80% gearing that applied for management of financial compliance during the course of the year.

We proceeded to present a variety of analysis on Ofwat's prescribed scenarios, outlining the additional debt we can raise (while staying within our gearing covenants) and therefore the remaining headroom. We present that there is headroom on all scenarios except the Ofwat combined scenario and the 10% totex overspend where we would need to suspend dividend payments and inject additional equity.

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	Headroom (£m) AMP7	Headroom (£m) AMP8
Base Case - April 2019 BP	16.7	16.6
(Base Case - September 2018 BP)	23.3	23.0

(£m, in outturn prices)

	Ofwat's Prescribed Scenarios	Impacts AMP7	Impacts AMP8	Additional Debt AMP7	Additional Debt AMP8	Remaining Headroom AMP7	Remaining Headroom AMP8	Further Funding Solution AMP7	Further Funding Solution AMP8
1	10% Totex overspend over 5 years	- 29.7	- 29.7	+ 32.6	+ 34.2	No Headroom		+ 14.7	+ 31.0
2	ODI penalty (3% of RoRE) in 1 year	- 2.5	- 3.0	+ 2.5	+ 2.7	14.2	11.4	-	-
3	1% inflation increase over 5 years	+1.0%	+1.0%	+ 11.6	+ 12.2	8.8	3.3	-	-
4	1% inflation decrease over 5 years	-1.0%	-1.0%	- 9.4	- 8.3	21.7	25.1	-	-
5	5% increase in bad debt over 5 years	- 0.1	- 0.1	+ 0.1	+ 0.1	16.6	16.4	-	-
6	2% increase in interest rates	- 5.0	- 6.1	+ 5.3	+ 6.7	12.7	8.7	-	-
7	Penalty (3% of revenue) in 1 year	- 1.9	- 2.1	+ 2.0	+ 2.2	14.7	12.4	-	-
8	Intercompany Financing Scenarios	-	-	-	-	-	-	-	-
9	Combined Scenario	- 37.3	- 38.1	+ 36.6	+ 35.7	No Headroom		+ 22.0	+ 30.0

	Company Specific Scenarios	Impacts AMP7	Impacts AMP8	Additional Debt AMP7	Additional Debt AMP8	Remaining Headroom AMP7	Remaining Headroom AMP8	Further Funding Solution AMP7	Further Funding Solution AMP8
1	Cyber attack fines - 4% of Turnover	- 2.8	- 3.2	+ 3.0	+ 3.3	13.7	10.4	-	-
2	Water Quality Failure	- 6.4	- 7.1	+ 8.4	+ 8.3	9.2	0.1	-	-
3	Loss of high quality staff	- 2.6	- 2.8	+ 3.0	+ 3.3	13.7	10.4	-	-
4	OPEX underperformance - Historical	- 4.1	- 4.2	+ 4.7	+ 4.8	12.1	7.2	-	-
5	AMP6 Efficiency Programme failure	- 15.7	-	+ 16.4	+ 0.3	1.6	0.1	-	-
6	Bond Sinking Fund waiver requirement	- 4.2	-	+ 4.6	+ 0.1	12.1	11.9	-	-
7	Pension costs on DB scheme	- 7.2	- 6.4	+ 7.9	+ 8.9	10.1	4.4	-	-
8	Redemption costs for Index Linked Bond	-	- 2.0	+ 0.0	+ 2.3	16.7	14.3	-	-
9	Combined Scenario (No.1 & 4 & 5)	- 22.6	- 7.3	+ 23.9	+ 0.3	No Headroom		+ 6.0	+ 2.0

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Our Board has also obtained a signed undertaking from our two main shareholders to provide financial support in the event of an extreme scenario. We stated that on the basis of this assessment of potential calls on the headroom we have available within our plan, and the accompanying longer-term projections, together with the contingent support we have from our shareholders, we will be resilient on our planned capital structure (and by implication on the notional structure used for price setting purposes) through to 2030.

We also state that we would seek to rely on the 'Substantial Adverse Effects' clause in the licence and reopen the PR19 final determination if necessary.

Below we show how our credit ratios under our actual structure are consistent with the target credit rating agency ratios:

Credit Ratios	Baa Criteria	2020-21	2021-22	2022-23	2023-24	2024-25
Adjusted Interest Coverage Ratio	>1.5	1.84	1.88	1.85	1.97	2.06
Gearing	<70%	67.1%	68.3%	69.2%	69.2%	68.8%

We are significantly below the gearing threshold of 80% and also above the 1.5 AICR threshold, suggesting we have headroom in the plan.

SES.RR.A6: *The company should ensure it is using the correct assumptions, including the cost of debt without a company specific adjustment, for the notional company in assessing the key financial ratios.*

We consider that we are using the correct assumptions, including our assumptions on the company-specific adjustment for cost of debt. In the event that Ofwat does not allow the company-specific adjustment, the Board will take the practical steps required to ensure the company remains financially resilient.

Below are the key modelling assumptions used within our notional and actual financial modelling.

Assumptions	Actual structure	Notional structure
Nominal Cost of Debt for Fixed Rate Debt	Fixed Rate Debt: 4.14%	Fixed Rate Debt: 4.36%
Nominal Cost of Debt for Fixed Rate Debt	Index Linked Debt: 2.87%	Index Linked Debt: 2.57%
Nominal Cost of Debt for Floating Rate Debt	Actual amount (c.1.8%)	No inputs (all debt converted into Index linked debt or fixed rate debt)
Gearing	Actual Gearing (average of 69.6% in AMP7)	Notional Gearing (average of 61% in AMP7)
Taxable Profit Adjustment	Nil	c.-£3.3m/year adjustment to have allowed tax consistent between actual and notional structure

SES.RR.A7: *The company should remove the uncertainty mechanism for lead or provide convincing evidence it is necessary given the uncertainty provisions of the licence. The company should remove the uncertainty mechanism for business rates or provide convincing evidence that adequate protections are not already in place given totex cost sharing arrangements. If the company retains an uncertainty mechanism in its revised business plan, it should ensure the proposal is underpinned by RoRE assessment in accordance with section 10.4.3 of the PR19 methodology.*

We have removed the proposed uncertainty mechanisms for changes in lead standards and business rates. We still consider that changes to these two items are outside of our control and could be financially material but we will make use of the existing arrangements in our licence in the event that there are changes.

SES.RR.A8: *The company should amend its overall assessment of RoRE outcomes or provide convincing evidence to explain why it is reasonable to assume totex outcomes should be asymmetrically skewed to the downside within an incentive based regime.*

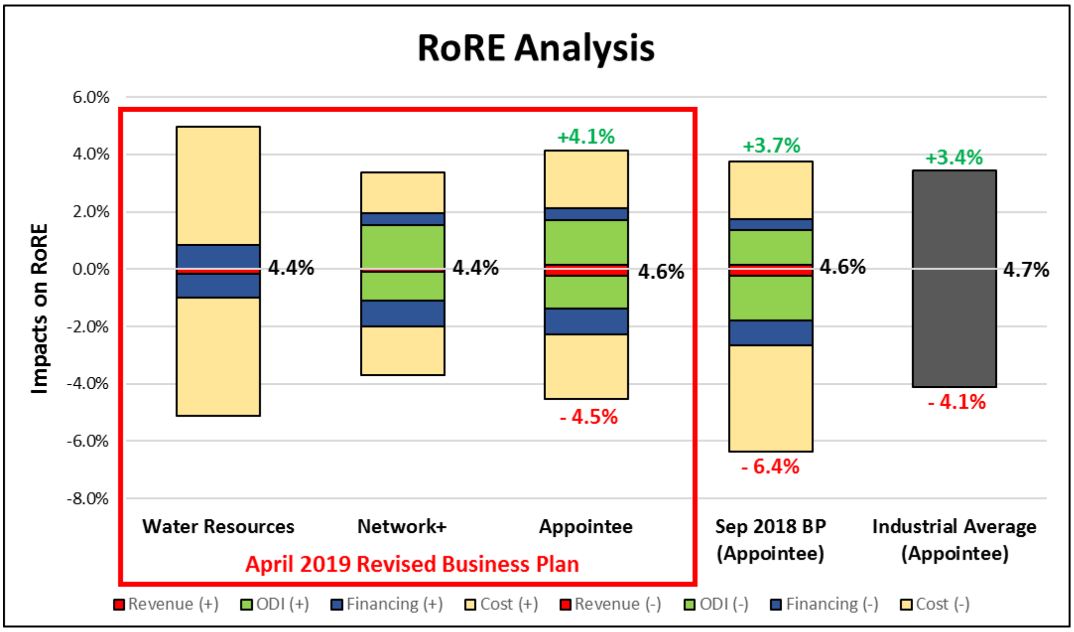
In our September 2018 Business Plan submission, we presented our assessment of RoRE scenarios for our appointed business alongside the water resources and water network plus components. We provided a detailed explanation of our approach to assessing uncertainty and the impact of uncertainty on the RoRE range. The conclusion of our RoRE analysis was:

- There is more downside than potential upside for returns to equity in our plan
- ODI incentives have strengthened – and contain more downside than upside – but are still not as strong as the cost challenges incorporated in our plan
- Revenue and financing variability are, by contrast, relatively modest in comparison to ODIs and cost variability.

In its Initial Assessment of our plan, Ofwat provided feedback that there was insufficient evidence to support the assessment that totex outcomes should be asymmetrically skewed to the downside within an incentive-based regime.

RoRE analysis

In response to Ofwat's feedback we have carried out a re-assessment of the RoRE analysis. This shows that the average return on regulated equity for the appointed business as a whole in our proposed plan continues to be 4.63%; however, the skew towards the downside has been reduced, as can be seen below. In reassessing the RoRE ranges we re-evaluated the impact of uncertainty based on our risk management and mitigation procedures to ensure we were considering a realistic set of potential scenarios.



Assessment of the impact of uncertainty

As described in our September 2018 submission, the RoRE assessment takes a different approach to assessing financial resilience by considering the probability as well as magnitude of potential financial shocks. This approach involves assessing the potential impact of events that have a one in ten chance of occurring and whether they enhance returns to equity or reduce them. The RoRE assessment only takes two likely values from the upside and downside impact of events under the 12 common headings below:

1. Financing
2. Revenue
3. Water trading incentive revenue
4. Water trading incentive export revenue
5. Outcome Delivery Incentives (excl. C-MeX and D-MeX)
6. Costs
7. Water trading export costs
8. Costs including uncertainty mechanisms
9. D-MeX
10. Retail revenue
11. Retail costs
12. C-Mex

As before, factors 3, 4 and 7 are not applicable as our plan does not include any new water trading proposals and we are not including any uncertainty mechanisms so the impact of factor 8 is the same as the impact of factors 6 and 11.

The notable change in the way in which we have assessed the impact of the different events has been through reassessing the probability of them occurring. This has taken account of the risk management procedures we have in place and provides a more realistic assessment of how likely they are to occur. In particular we have reassessed management mitigation plans to address the following key risks:

- Cyber-attack fines
- Water quality failure
- AMP6 efficiency programme failure
- Pension costs on defined benefit scheme.

In the following table, which is an extract from the Ofwat financial model, we show the impact of the factors tested on the RoRE range (grey cells indicate the factor does not impact on the particular price control).

Sensi cases	Appointee	WR	WN
Base case	4.61%	4.35%	4.38%
Financing upside	0.43%	0.83%	0.41%
Financing downside	-0.90%	-0.83%	-0.90%
Revenue upside	-	-	-
Revenue downside	-0.08%	-0.16%	-0.08%
Water trading incentive revenue impact upside	-	-	-
Water trading incentive revenue impact downside	-	-	-
Water trading incentive export revenue impact up	-	-	-
Water trading incentive export revenue impact do	-	-	-
ODI upside	1.08%	-	1.14%
ODI downside	-1.30%	-	-1.36%
Wholesale costs after uncertainty mechanism up	1.55%	4.13%	1.42%
Wholesale costs after uncertainty mechanism do	-1.80%	-4.13%	-1.68%
Water trading export costs impact upside	-	-	-
Water trading export costs impact downside	-	-	-
D-Mex upside	0.05%		0.06%
D-Mex downside	-0.11%		-0.11%
Retail revenue upside	0.15%		
Retail revenue downside	-0.15%		
Retail costs upside	0.44%		
Retail costs downside	-0.44%		
Retail ODI upside	-		
Retail ODI downside	-		
C-Mex upside	0.09%		
C-Mex downside	-0.18%		

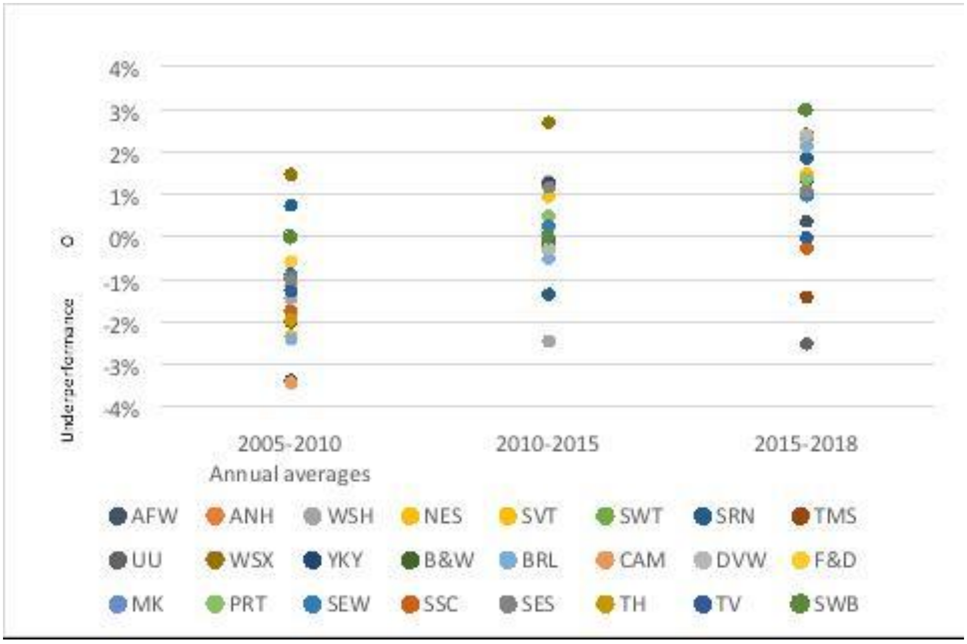
Explanation of the downside skew

The re-assessment of RoRE has resulted in a reduction in the downside skew, however a slight downside skew does still exist.

In its Initial Assessment, Ofwat suggests that companies typically outperform on totex rather than underperform. It presented analysis from PwC which shows historical cost performance across 2005 to 2018, which concluded that there is no evidence of a downward skew and that there is a positive skew towards totex underspending.

Analysis of our own historical totex data suggested that we are more likely to overspend (underperform) than underspend (outperform) Ofwat's allowances. We note that other companies also argued that totex allowances for PR19 could be set at a level that would make underperformance more likely than outperformance.

In light of Ofwat's feedback we have reviewed evidence on historical totex performance. We conducted analysis on historical totex performance against allowances set in the PR04, PR09 and PR14 final determinations. For PR04, we compared opex and capex data from the June annual returns to the PR04 FD allowances. For PR09, we compared opex and capex data from the OIA and CIS reconciliation models to the PR09 FD allowances. For PR14, we compared totex data from company APRs to the PR14 FD allowances.



Source: SES analysis of opex, capex and totex allowances and actual cost data

Our analysis has found that, over the 2005 to 2018 period, the annual average totex performance for the industry appears to be about equal. The relationship over 2005 to 2010 suggests a downside skew, however the data for 2010 to 2015 and 2015 to 2018 is less clear. The annual average totex performance tends to be centred around zero and there is no clear trend towards out or under performance.

The analysis we have conducted indicates it is therefore not inappropriate to have a downside skew. There is no evidence to suggest that companies have systematically outperformed on totex over time. A balanced interpretation of the evidence suggests that some companies have outperformed and some have underperformed and, on average, companies do not tend to outperform by more than they underperform.

Our updated analysis has resulted in a more symmetrical RoRE range, although certain downside skewing remains, which is explained by the risks that remain, primarily from financing and costs perspective for our business.

***SES.RR.A9:** There is inconsistency between the notional cost of equity in financial model and data tables. The company should ensure its subsequent submission is consistent in this respect.*

Data tables and financial model are now consistent and complete.

***SES.RR.B1:** The Company should provide a clearer link between its internal risk management and mitigation procedures and introduce this into the RoRE analysis.*

In its Initial Assessment of our plan Ofwat highlighted that there was insufficient evidence on risk management and no discussion of mitigation measures in RoRE analysis.

We have now further aligned our internal risk management and mitigation procedures and introduced the effects of this into the RoRE analysis, with the result of reducing the asymmetrical downside skew.

In particular, we have reconsidered the mitigations that are provided by effective internal risk management in several areas, such as the systems-based controls in place to reduce the likelihood and impact of a cyber-attack, and therefore reassessed the overall impact on the RoRE range.

We already have a very mature risk management process in which key risks and mitigations are reviewed on a regular basis by our Audit Committee. This includes assessing the ability of our internal management processes and controls to mitigate key risks such as totex overspends, water quality matters and delivery of our transformation and efficiency programmes and, where necessary, enhancing the mitigating actions. We have therefore reconsidered this internal risk management process and mapped the relevant mitigating processes and controls to the RoRE analysis with the subsequent results noted in this chapter.

CHAPTER 7

Accounting for past delivery

Accounting for past delivery

Our Business Plan for 2020 to 2025 is built on solid foundations and a strong track record of delivery over many years. Our performance in key areas such as supply interruptions, mains bursts, water quality customer contacts and leakage has set the bar for the industry. We are forecasting to achieve all but four of our 23 performance commitments set at PR14 and this plan will go further still with even more stretching targets to deliver more of what matters to our customers.

In its Initial Assessment, Ofwat was confident in our ability to deliver our plan given our track record and recognised the sufficient and convincing evidence provided in support of our actual and forecast performance over the current five-year period 2015 to 2020. Ofwat also highlighted that improvement measures are in place in the few areas where results are not as good, with the Company also having a good understanding of the drivers of performance in most areas. The assessment also emphasised that we have had no major incidents and that complaints handling is improving.

In total there were five actions in this area to be addressed in our resubmission which relate to updating forecasts, providing additional and updated evidence and refreshing PR14 reconciliations to reflect actual performance.

The first three actions from Ofwat to be addressed in our resubmission are as follows:

SES.PD.A1: PR14 Land sales: SES Water is required to correct the data error in table App9 and provide more evidence to support the forecast trajectory.

We assume the error referred to relates to the point raised in response to our PR14 reconciliation submission in July 2018. This was addressed in the September 2018 Business Plan submission. We note that the formula built into the table has been corrected which materially changes the output. We have also adjusted inflation for 2018/19 to account for the outturn position. The land sales forecast has been updated for 2018/19 to reflect the sale of one property.

SES.PD.A3: PR14 Service incentive mechanism: SES Water is required to provide more evidence to support the forecast trajectory in table R10.

More evidence has been provided in the Business Plan Data Table Commentary R10.

SES.PD.A4: PR14 Totex: SES Water is required to provide more detailed information on the re-phasing of the capital program and expected efficiencies referred to in the evidence for table WS15.

More detailed information has been provided in the Business Plan Data Table Commentary WS15.

We received a further two actions to be addressed alongside the reporting of performance for this year (2018/19) on 15 July 2019:

SES.PD.A2: PR14 Outcome delivery incentives: SES Water is required to update its forecast for 2019-20 performance to take account of the actual 2018-19 performance for all its performance commitments. We expect the company to pay particular focus where we found the evidence provided in its business plan for the 2018-20 forecasts to be insufficient which was for:A7: Water softening programme; and A6: Taste, odour and discolouration (number of contacts received)

We will update all data by 15 July. We already have a confirmed position for 2018/19 for performance commitments A5 (DWI index of water quality) and A6 (taste, odour and discolouration contacts) as they are based on calendar year performance. These have been updated. We consider that we have now met the performance commitment A7 (water softening programme) and further explanation is provided in the Business Plan Data Table Commentary App5.

SES.PD.A5: PR14 reconciliations: Further to the actions we have set out to address our concerns over the evidence provided in its business plan for the individual reconciliations, we will require the company to refresh all of its PR14 reconciliations to replace its 2018-19 forecast performance with 2018-19 actual performance and update the evidence for its forecast 2019-20 performance taking into account of the actual 2018-19 performance.

Where information is known we have updated our position (see relevant actions). We will provide an update based on outturn for 2018/19 by 15 July.

CHAPTER 8

Confidence and assurance - revised and enhanced Board statements

Securing confidence and assurance

The Board of directors of SES Water recognise the responsibility and privilege they have in leading a business that provides an essential public service. As a monopoly provider, we are acutely aware of the importance of strong governance and transparency in ensuring the trust and confidence of customers and the legitimacy of our Company.

The Board has taken an active role in the development of the Business Plan for 2020 to 2025 and the medium to long-term through the development of the Water Resources Management Plan (WRMP); through a systematic governance process that has enabled it to challenge and satisfy itself that the plan is deliverable and delivers the best outcomes for customers at an affordable price. It has enhanced the already strong approach to governance which is led by the members of the Board.

The Board has reviewed Ofwat's Initial Assessment of our Plan and recognise that the Board Assurance Statement provided in support of our September 2018 submission did not meet Ofwat's requirements and our customers' expectations in describing the detail of all the assurance activity undertaken and providing evidence to support it.

Ofwat identified a number of actions related to securing confidence and assurance of the plan which we have addressed in our resubmission. This includes providing six compliant Board assurance statements to cover key aspects of our plan, further explanation of how we will communicate changes to our dividend policy and further development of our executive pay policy to meet the expectations of Ofwat's 'Putting the sector in balance' position statement. We have also provided Ofwat an updated financial model to address some minor inconsistencies in our original data tables, explained the assurance process taken around our tax forecast, and provided a revised App1 and App4.

To ensure that our customers and stakeholders have confidence that our Board is accountable for our Business Plan, in this resubmission we have provided an updated Board assurance statement that covers each of the assurance requirements set out by Ofwat in the PR19 Final Methodology. We have also given more detail on other areas of non-compliance even where no action was specified by Ofwat. This replaces the statement provided in our original submission and covers both our original plan and our resubmission.

Addressing Ofwat's actions

Board assurance statements

Ofwat identified that six of the Board assurance statements required were either incomplete or not included in our original submission. We have therefore produced updated Board assurance statements for each area to address the actions and more information on detailed Board activity is included in Appendix A.CA.1. The updated statements are included in our revised Board assurance statement which is provided in full at the end of this chapter. Ofwat requires a compliant Board statement for the following areas.

SES.CA.A1: *Assurance that large investment proposals are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers.* ***See page 97***

SES.CA.A2: *Assurance that the Board has identified the risks associated with delivering the plan (SES.CA.A2).* ***See page 97***

SES.CA.A3: *Assurance that the risk mitigation and management plans the Board has in place are appropriate.* ***See page 105***

SES.CA.A4: *Assurance that the Company's business plan is financeable on both the notional and actual capital structure and the plan protects customer interests in both the short and long term. The statement should clearly set out the steps taken to provide this assurance.* ***See page 106***

SES.CA.A5: *A statement that the Company's business plan provided sufficient and convincing evidence covering all necessary areas, that the Company's full Board had provided assurance that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term.* ***See page 106***

SES.CA.A6: *A statement that the Company's business plan provided sufficient and convincing evidence that the company's full Board has provided comprehensive assurance to confirm that it will monitor delivery of its outcomes to ensure they meet its relevant statutory and licence obligations and has explained how it will do this.* ***See page 107***

Dividend policy

In our September 2018 Business Plan submission, we proposed an updated PR19 dividend policy statement in line with the expectations of the 'Putting the sector in balance' position statement. This included a commitment to explain the way in which decisions associated with dividends are arrived at in our Annual Report and other publications to ensure greater transparency around the decision making process.

Ofwat recognised that our submission provided sufficient evidence that our proposed dividend policy takes account of delivery of obligations and commitments to customers and other stakeholders, and refers to all of the required elements of 'Putting the sector in balance'. One required action was identified by Ofwat.

SES.CA.A7**:** *The company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in "Putting the sector in balance, to include:*

- *Clear Board commitment to signal changes to stakeholders*

Please provide an update on the steps you are taking to fully meet expectations as set out in our putting the sector in balance position statement

The Board is fully committed to adopting the expectations and our dividend policy below commits to provide greater transparency and clarity to all stakeholders about how the Board sets the dividend level, especially focusing on explaining how decisions take account of delivery for customers over the price control period. Publishing this policy in our annual reports going forward gives a strong signal to all stakeholders that we are committing to a step change in this area.

In our annual reports we will publish details about how dividends declared or paid have been determined, how these relate to our policy and where we may need to make changes to our policy. This will also be clearly explained and signalled to stakeholders using a range of channels including our annual ‘Keeping it clear’ document and on our website.

Our proposed PR19 dividend policy statement (included in September 2018 submission):

“The Board considers that the base level of ordinary dividend for the appointed business should reflect the return on regulatory equity (defined as Regulatory Capital Value less net debt) allowed in the regulator’s most recent price review, subject to the Company having adequate resources available to fulfil its overall service commitments and its other financial obligations. This includes compliance with the covenants associated with its index-linked bond (which are designed to protect the interests of the Company’s creditors).

The Board will consider variations from this base level of ordinary dividend reflecting:

- *The overall level of service delivered to customers, compliance with statutory obligations and progress with the delivery of regulatory and other obligations*
- *Financial performance against regulatory assumptions and internal targets*

The Board will explain the way in which these factors have been taken into account in arriving at the dividend declared in the Company’s annual report, and other publications, and will refer to any quantitative analysis required by reporting standards in support of such explanations.”

This reflects the Board’s commitment to ensuring that strong corporate governance supports decision making at all levels throughout our business. This extends to changing the manner in which decision-making around certain matters – such as dividends, gearing levels and executive pay – are made by the Board and its committees.

The Board is fully committed to the factors Ofwat has indicated should be taken into account in assessing dividend policies included in companies’ plans, and we believe that our enhanced dividend policy above will allow the Board to fully take into account:

- Whether the company is meeting its obligations
- Whether commitments made to customers are being adhered to
- Appropriate adjustment for under or out performance as necessary, including benefits sharing
- Employee interests, including any pension obligations
- Consideration of actual capital structure, particularly reflecting the base allowed return on equity included in the PR19 Final Determination
- The need to finance future investment
- Financial resilience.

Our September 2018 Business Plan submission (page 131) provides further detail on our approach in each of the above areas.

Executive pay

The Ofwat action associated with our executive pay policy was as follows.

SES.CA.A8: *The company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020 to 2025 as set out in 'Putting the sector in balance', to include:*

- *visibility and evidence of substantial linkage of executive remuneration to delivery to customers*
- *clear explanation of stretching targets and how they will be applied*
- *Commitment to publish the executive pay policy for 2020 to 2025 once it has been finalised.*

Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.

The Board fully agrees with Ofwat's expectations with respect to companies being transparent about how executives are remunerated and especially how any performance-related element is linked to performance for customers. The Board is committed to ensuring this transparency is provided to all stakeholders, and is committed to publishing our executive pay policy for 2020 to 2025 in our annual reports, together with performance results and associated pay awarded through this policy.

Since September 2018, our Remuneration Committee has continued to develop an enhanced and updated executive pay policy, reviewing specific step changes ahead of finalising it in advance of April 2020. In particular, these discussions have focused on strengthening the link between executive pay and exceptional delivery for customers, including service performance, cost savings and wider customer interests. The Board is considering various factors in adopting the expectations:

- Redefining corporate KPIs as customer pledges
- Redefining financial performance as financial resilience – in recognition that financial resilience is far broader than good financial performance
- A greater emphasis and weighting on the delivery of the customer service components
- Clearer criteria on what constitutes exceptional delivery for customers
- Retaining personal targets to allow the Board to include specific targets for individuals.

To ensure that the policy and associated targets are sufficiently stretching, the Board will ensure any outperformance is only payable if the Company is earning a net reward for the delivery of the customer pledges in any one year. This will be particularly demanding given our targets for 2020 to 2025 are typically in the industry upper quartile.

In addition, introducing financial resilience as opposed to simply financial performance will ensure that executives have a responsibility to ensure the long-term financial sustainability of the Company and this will be assessed using a set of measurements such as bond ratios, totex efficiency and credit ratings.

Through our Remuneration Committee, we are committed to continuously reviewing executive pay policies over time and, where they develop and change, we will explain the reasons in our Annual Report and signal changes to stakeholders.

We commit to publishing our updated executive pay policy by April 2020.

Financial models, data tables, outcomes, risk and return (SES.CA.B1)

We have provided an updated notional and actual financial model. We do not agree that the signage is incorrect on 'Trade and other payables - Wholesale creditors ~ residential retail'. 'Capex on assets principally used by retail,' 'Cost of equity (used in WACC) - actual structure' and the 'Charge for DC schemes' are now included in the financial model.

Board assurance statement

The Board of directors of SES Water recognise the responsibility and privilege it has in leading a business that provides an essential public service. As a monopoly provider we are acutely aware of the importance of strong governance in ensuring the trust and confidence of customers and the legitimacy of our Company.

We have taken an active role in the development of the Business Plan for 2020 to 2025, and this resubmission, through a systematic governance process that has enabled the Board to challenge and satisfy itself, and gain assurance that the plan is deliverable and delivers the best outcomes for customers at a fair price.

We have produced an updated Board assurance statement that covers each of the assurance requirements set out by Ofwat and that addresses the specific actions identified in the Initial Assessment. This covers our September 2018 Business Plan submission and this resubmission.

Business planning statements

Ofwat assurance requirement 1: How the Board has challenged and satisfied itself that all the elements add up to a Business Plan that is high quality and deliverable.

The Board is satisfied that all elements of our PR19 Business Plan submission, including the revisions made following Ofwat's Initial Assessment, add up to a high-quality plan that is affordable and deliverable. It reflects our customers' priorities, contains appropriate and stretching performance commitments, will deliver long-term service resilience and offers good value for money.

The Board has been regularly and intensively engaged throughout the development of the Business Plan, providing strategic leadership and challenging itself to ensure it acts in the long-term interests of customers.

- Dedicated, strategic reviews at key stages of the development of the plan have been completed and a formal progress report on the development of the plan was presented at every Board meeting from November 2016, prepared by the dedicated PR19 steering group
- Dedicated committees, chaired by independent non-executive directors, have focused on particular aspects of the plan, including a PR19 Financing Committee

chaired by the senior independent non-executive director, as well as energy, pension and governance committees

- Each independent non-executive director was given responsibility for one of the four key themes in our plan – customer service, affordability, resilience and innovation – to enable more detailed engagement and challenge and to provide ongoing updates to the full Board on activity and progress
- The Company carried out the most extensive customer engagement to date, using independent research experts to conduct activity and accurately interpret the results, which were reviewed at each stage by the Board, including presentations by the research providers at Board meetings. Key findings included overall acceptability of the plan which showed that 76% of customers found the plan acceptable
- The Board engaged with the Customer Scrutiny Panel (CSP) throughout the preparation of the Business Plan
- External assurance and challenge was provided to the Board through external parties including Mott MacDonald and EY who reviewed and assured technical and financial aspects of our plan. The Audit Committee has played an active role in agreeing the scope, process and timetable for external assurance, together with ensuring that the external parties are appropriately experienced, objective and qualified.

Ofwat assurance requirement 2: How it has challenged and satisfied itself that the overall strategy for data assurance and governance processes delivers high-quality data

The provision of high-quality data is a priority for the Board and there are well established procedures and governance arrangements in place for managing and assuring data. The Board confirms that the plan is based on accurate and reliable data and a range of suitably qualified external assurance providers have been used to provide additional reassurance in key areas.

- We have demonstrated our high-quality and consistent approach to assuring data by achieving the ‘targeted’ category in Ofwat’s Company Monitoring Framework for the three years since it was introduced
- The plan has been based upon historic performance data that has been subject to third party assurance as part of our ongoing performance reporting process, this involves:
  - Appropriately trained and experienced employees compiling performance data in accordance with documented and well-understood procedures
  - Reviews and verification of the performance data by more senior employees
  - External assurance by appropriately qualified, objective and experienced third parties
- The senior independent non-executive director who is chair of the Audit Committee was given responsibility for data assurance associated with the Business Plan and Audit Committee time was spent reviewing and approving the plans for data assurance
- We have used the same external providers to assure our future performance measures and expenditure forecasts as we have for reported historic data – using their knowledge and expertise in understanding our current performance and reporting mechanisms to accurately assess future performance

- All independent assurance reports have been considered by the Board in agreeing to the plan being submitted.

Ofwat assurance requirement 3: How it has challenged and satisfied itself that the Business Plan will enable the company to meet its statutory and licence obligations, now and in the future and take account of the UK and Welsh Government's strategic policy statements.

OFWAT ACTION SES.CA.A1 *– Provide a compliant assurance statement*

The Board confirms that the Business Plan will enable the Company to meet its statutory and licence obligations, now and in the future and take account of the UK Government's strategic policy statement.

- The Board has considered and acted on the guidance issued by Ofwat, the Environment Agency, Natural England and the Drinking Water Inspectorate and assured itself that the plan meets statutory and regulatory obligations (both current and future) through regular written and verbal briefings by the Company executives
- The Board has reviewed and discussed the UK Government's strategic policy statement to ensure the plan supports its long-term objectives – this led to the incorporation of fast-track demand reduction activity into early years of the Water Resources Management Plan to reduce the long-term risk to water supply resilience
- The objectives of the Government's 25-year Environment Plan and the recommendations of the National Infrastructure Commission have been considered in our Water Resources Management Plan (which is aligned with our Business Plan), as well as being taken into account in our response to the Water Industry Strategic Environmental Requirements (WISER), including the National Environment Programme
- The Board has assured itself that the plan delivers against all its statutory and regulatory obligations through review of new and existing legislation and regulation and proactive engagement with regulators and key stakeholders in the months and years running up to the planning period. This has included key stakeholders and regulators attending Board meetings, independent non-executive directors attending Ofwat and other industry events and one to one meetings
- The Quality and Compliance Director has responsibility for and advises the Board on water quality, the externally accredited ISO quality and environment systems and provides independent internal assurance and compliance, including on health and safety
- A Certificate of adequacy and a risk and compliance statement is published in our Annual Report confirming the Company has met its statutory licence and regulatory obligations.

Ofwat assurance requirement 4: How it has challenged and satisfied itself that its plan will deliver operational, financial and corporate resilience over the next control period and the long term through its governance and assurance processes, taking account of its track record of performance.

OFWAT ACTION SES.CA.A2 *– Provide a compliant assurance statement*

The Board is satisfied that the Business Plan will deliver operational, financial and corporate resilience to at least 2030, through its governance and assurance process and taking account of its track record of assurance.

- The dedicated independent non-executive director with responsibility for resilience participated in a number of Company workshops to assess risks and identify potential mitigations, worked with the Company's resilience lead to develop and implement a resilience in the round framework and was responsible for reporting back to the Board on progress
- We commit to conducting a third-party peer review of our resilience work undertaken to date and assurance of our future action plan that will be submitted by 22 August 2019
- Resilience was a focus at each Board strategy day in the lead up to the Business Plan submission and the Board was involved in decision making associated with key resilience capital investment and performance commitments associated with delivering resilience including our bespoke commitment to supply all customers from more than one treatment works
- In January 2018 we produced our Long-Term Vision document that sets out the future challenges that we are facing and provides the context for our plan
- The Board ensured there was alignment between the Water Resources Management Plan, which takes a longer-term (60 year) perspective and the PR19 Business Plan, which secures the funding for the first five years of activity - to ensure that the company can address future challenges and deliver resilient water supplies
- We publish a long-term viability statement in our Annual Report, the latest of which gives assurance for the period until 2025. Whilst we consider that we have adequate headroom for most plausible scenarios, and combinations thereof, through to 2030, the Board considers that additional headroom might be needed simply because the probability (albeit relatively remote) of more than one event or combination of events occurring increases with the longer time horizon being considered. The Board has therefore obtained a signed undertaking from our two main shareholders – and the intermediate holding company Boards – of their intent to provide financial support in the scenarios described to ensure that we are able to continue financing our functions and deliver our commitments to customers
- The results of the financial stress testing undertaken to assess our long-term viability were reviewed and approved by the Audit Committee
- Principal risks and mitigations are published in our Annual Report and our Risk Register is reviewed by our Audit Committee on a six-monthly basis
- The Nomination Committee is responsible for planning orderly succession to the Board and ensuring effective succession planning is in place for senior executive positions which is an essential aspect of corporate resilience. This can be evidenced by the successful recruitment of a new finance and regulation director and smooth transition with the departing holder of the role, at a key point in the Business Plan process.

Ofwat assurance requirement 5: How it has challenged and satisfied itself that it will enable its customers' trust and confidence through appropriate measures to provide a fair balance between customers and investors (which include outperformance

sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement with customers on issues such as its corporate and financial structures.

The Board is satisfied that the Business Plan will underpin a continued level of trust and confidence from the customers and communities we serve through promoting transparency and engagement on the issues that matter to them.

- The Board works within a governance framework that is laid down by the UK Corporate Governance Code and the Companies Act
- SES Water is jointly owned by Osaka Gas and Sumitomo Corporation with both holding a 50% share in our ultimate UK-based holding company Sumisho Water UK Ltd. The Group corporate and financial structure is fully disclosed in our Annual Report, together with details of our dividend policy and our executive remuneration. We also include a long-term financial viability statement, most recently for the period to 2025
- In addition, we have committed to producing, 'Keeping it clear – a customer-friendly guide to how we are owned, run and financed' - on an annual basis with the first issue published in 2018 (included in Appendix A.OC3). This was promoted through Talk on Water, our online customer community, to generate feedback for future iterations
- Having significantly reduced our regulatory gearing level from c77% in March 2018 to c60% in March 2019, we have committed to maintaining our regulatory gearing below the levels that Ofwat deems reasonable throughout delivery of our Business Plan between 2020 and 2025. We accept the illustrative benefit sharing mechanism set out in 'Putting the sector in balance' if actual gearing breaches the threshold required
- Our Annual Report provides full transparency on our performance. We use feedback from customers and stakeholders to ensure it is accessible and understandable and produce a customer-friendly online version each year to increase accountability
- In the event that outperformance payments are earned during the period the Board will take a judgement "in the round" on how best to implement any potential customer benefit sharing through future bills
- Both our executive remuneration and dividend policy are already linked to customer performance and aligned with the Company strategy. We will further review our executive pay policy in 2019/20 so it gives appropriate weight to performance for customers and increase the transparency of our decision making and reporting process
- We have established a dedicated governance committee, chaired by the senior independent non-executive director, to consider ongoing requirements and enhancements to our corporate governance and transparency to further promote trust and confidence. Actions so far have included publishing summary Board minutes on our website and planning independent non-executive director participation in employee forums
- We will continue to track customer confidence levels through our quarterly survey and ongoing engagement activity.

Ofwat assurance requirement 6: How it has provided ownership of the overall strategy and direction of the plan in the long term.

The Board confirms it has provided ownership of the overall strategy and direction of the plan in the long-term.

- Substantial time has been allocated to the PR19 and WRMP process through four Board strategy days and regular Board meetings since November 2016
- Board members have taken an active role in the development of key areas of the plan through sub-committees, chaired by independent non-executive directors
- In January 2018 we produced ‘Looking Forward’, our long-term vision document to set the strategic direction for the plan
- Board members have attended the Customer Scrutiny Panel (CSP) and the Chair of the CSP and other panel members have provided regular updates to the Board and held private sessions with independent non-executive directors
- All strategic decisions have been made at Board level.

Customer engagement statements

Ofwat assurance requirement 1: Assurance that the company’s Business Plan has been informed by customer engagement.

The Board confirms that the plan has been informed by the most comprehensive customer engagement programme to date.

- The Board allocated responsibility for oversight of the customer engagement programme to an independent non-executive director with extensive consumer marketing experience. This included signing off the overall engagement strategy at the start of the process, selecting credible suppliers through a competitive pitch, reviewing and challenging activity proposals and attending key CSP meetings where results were presented
- The strategic approach to customer engagement for PR19 – including the three phases of research – was agreed by the Board in advance of delivery
- The Board was involved in decisions related to the use of external, independent research experts to ensure the engagement undertaken was of the highest quality. The research providers have since provided additional assurance that the customer samples used were both representative and robust
- The Board reviewed the outcomes of each of the three phases of customer research and further developed the plan in light of those results. This included receiving debriefs directly from the independent experts who conducted the research
- The Board took an active role in ensuring that the Company’s social tariff scheme was enhanced to ensure it meets the needs of all customers resulting in the redesign of the scheme
- Members of the Board have regularly attended meetings of the CSP
- The Board reviewed and approved the draft Business Pan document that was subject to customer consultation and informed the acceptability testing, which found that 76% of customers accepted the plan
- The draft Business Plan customer-facing consultation document was also independently assessed with applicable modifications being agreed by the Board.

Ofwat assurance requirement 2: Assurance that the company’s Business Plan has

been informed by feedback from the company's CCG about the quality of its customer engagement and how this has been incorporated into its plan.

The Board confirms that the Business Plan has been informed by feedback from the Customer Scrutiny Panel (CSP) about the quality of the customer engagement and the extent to which customer views are incorporated in the plan.

- Members of the Board have attended CSP meetings on six occasions
- Independent non-executive directors held three private sessions with members of the CSP
- The CSP Chair has attended Board meetings and the CSP challenge log was made available to Board members
- The customer engagement programme has taken account of CSP views and feedback on an ongoing basis
- The Board has reviewed the CSP report which states: "The CSP is able to confirm to Ofwat that as a result of its involvement and analysis, it can provide positive assurance that SES Water has engaged effectively with its customers; that its plan does reflect identified customer priorities and that the resulting impact on bills appropriately accounts for the views of its customers. The CSP notes positively that the final version of the Business Plan is of a high quality, and SES Water has taken good account of CSP feedback."

Affordability statement

Ofwat assurance requirement: Assurance that the Company's Business Plan is affordable for all customers, including in the long-term and including appropriate assistance for those struggling, or at risk of struggling, to pay.

The Board confirms it has taken all reasonable steps to ensure that the Business Plan is affordable for all customers, including in the long term and including appropriate assistance for those struggling, or at risk of struggling, to pay.

- Ensuring water bills are affordable for all customers has been a primary consideration of the Board during the development of the Business Plan with regular updates to the Board by the Finance and Regulation Director
- We have committed to an average reduction in real-term (before the impact of inflation) bills of £16 over the 2020 to 2025 period and a further 6% average bill decrease between 2025 and 2030 so bills are affordable for all customers over the next ten-year period. This is despite increasing investment to deliver the improvements that customers want to their service
- In the lead up to 2020 we are on track to deliver significant efficiency savings through a dedicated programme closely monitored by the Board to enable us to deliver more for our customers at a lower cost through this Business Plan
- We are committed to keeping bills affordable and stable. In discussion with our CSP on 20 July 2018, we chose to spread the rise across the five years. Bills are therefore expected to increase from £204 in 2019/20 to £214 in 2024/25, averaging £207 across the five year period
- Over the current (2015 to 2020) period we have significantly exceeded our target to support customers struggling to pay through our Water Support Scheme. We intend

to more than double the number of people receiving the discount between 2020 and 2025 and have agreed the level of subsidy from our wider customer base through extensive engagement. Our shareholders have committed to continue to make up any shortfall in funding in the event of us exceeding our target

- We will also provide additional support to customers who are vulnerable for non-financial reasons and continue to provide proactive advice to customers on metering, water efficiency and payment options. We have proposed three new performance commitments that will improve our service in this area and the Board will monitor progress on a monthly basis through regular reporting and deep-dive sessions
- The Board has ensured that decisions have been made for the long-term, so that our Business Plan remains affordable for our customers now whilst mitigating affordability concerns in the future by not storing up significant and disproportionate expenditure requirements for later price review periods.

Outcomes statement

Ofwat assurance requirement 1: Assurance that the Business Plan will deliver – and that the Board will monitor delivery of – its outcomes and performance commitments.

The Board is confident that the Company will deliver the outcomes and performance commitments in its plan and is committed to ongoing monitoring of delivery.

- The Board monitors performance against the Company's PR14 regulatory commitments at each Board meeting (six per year) and carries out deep dives into progress against the five pledges on a regular basis, including at Board strategy days
- The Company is currently forecasting it will achieve or exceed all but four of its 23 performance commitments for 2015 to 2020 and understands the drivers of its current performance in each outcome area
- The Board has scrutinised and challenged evidence produced by the Executive that the Company can meet the stretching targets set out in the PR19 Business Plan
- We will continue to closely monitor our performance against our targets on a monthly basis and through ongoing deep dives. We are also strengthening the relationship between our independent non-executive directors and our management team and wider workforce to enable better understanding about the drivers of our performance
- The Audit Committee will continue to review our regulatory submissions, including our annual reports, price control compliance, risks and compliance statements and our future business plans
- The Audit Committee will also continue to review the effectiveness of our internal controls and risk management systems
- Both our executive remuneration and dividend policy are already linked to customer performance and aligned with the Company's strategy. We will further review our executive pay policy in 2019/20 so it gives appropriate weight to performance for customers and increase the transparency of our decision making and reporting process.

Ofwat assurance requirement 2: Assurance that the company's proposed outcomes, performance commitments and outcome delivery incentives (ODIs) reflect customer preferences and are stretching.

The Board is satisfied that our customer engagement programme has been comprehensive and high quality and has led to us developing a clear understanding of our customers' needs and priorities. We have set performance commitments and ODIs that reflect our customers' priorities and will drive improvements to our performance through appropriately stretching targets.

- The Board has been involved in both the planning of the customer research programme and has reviewed the results of each phase of research, including receiving comprehensive briefings from the independent experts who carried out the research. The Board was particularly involved in reviewing customers' willingness to pay for enhanced leakage and usage reduction targets, as well as the level and nature of social tariff support
- The targets proposed have been considered in relation to current performance and against the rest of the industry. Historical and projected upper quartile performance has been taken into account and, following Ofwat's Initial Assessment, we have reviewed our targets against those proposed by the wider industry and restated them where appropriate
- Incentive rates take into account the incremental cost of delivering the service and comprehensive research into customers' willingness to pay
- We commissioned an independent review by Frontier Economics to further assess our package of ODIs ahead of the April 2019 resubmission of our Business Plan to provide confidence that it is appropriate, well evidenced and deliverable
- The package of performance commitments and ODIs proposed in our Business Plan resubmission has been reviewed by and has the support of the Board.

Ofwat assurance requirement 3: Assurance that the Company's proposed approach to reporting on its performance commitments, ODIs and projections of outcomes is robust.

The Board is satisfied that the Company will take a robust and transparent approach to reporting on its performance commitments, ODIs and projections of outcomes.

- We will continue to use our well-established processes for assuring performance data that includes:
  - Appropriately trained and experienced employees compiling performance data in accordance with documented and well-understood procedures
  - Reviews and verification of the performance data by more senior employees
  - External assurance by appropriately qualified, objective and experienced third parties
- Our Quality and Compliance Director will continue to oversee our non-financial assurance
- The Audit Committee will continue to take responsibility for the review and assurance of performance data that is reported
- It will review documents required by Ofwat to be published by the Company including the Annual Report which incorporates regulatory accounts, performance against the PR19 final determination commitments and financial resilience measures
- We will continue to report performance on a quarterly basis to the CSP on customer outcomes with specific challenge sessions where required

- As part of our ongoing commitment to increased transparency, we commit to further enhancing our performance reporting, particularly in customer-friendly formats, to also include how our results compare to the wider industry.

Resilience statement

Ofwat assurance requirement: Assurance that the company's Business Plan has been informed by:

- **A robust and systematic assessment of the resilience of the company's systems and services**
- **Customers' views about managing resilience**
- **A comprehensive and objective assessment of interventions to manage customers' long-term interests.**

The Board is satisfied that the Company's PR19 Business Plan has been informed by a robust and systematic assessment of resilience of the Company's systems and services; customer views about managing resilience and a comprehensive and objective assessment of interventions to manage resilience in customers' long-term interests.

- The Board is confident that the Company is starting from a strong position in relation to all areas of resilience which can be evidenced through its consistently strong performance in all aspects of its business
- Every six months the Audit Committee reviews and challenges the Company risk register and management's assessments of the key risks faced by the business, the probability of their occurrence and the impact of mitigation measures. Additionally, at each meeting the Committee also performs deep dives into certain pertinent risk areas such as Brexit and cyber security
- Ahead of developing the Business Plan we carried out a full review of all risks facing the key parts of our business, their consequence and how resilient we are to them which was led by the independent non-executive director with responsibility for resilience and presented to the Audit Committee
- The Board will continue to play an active role in the development of our resilience action plan through regular updates and challenge sessions
- Third party review of our resilience assessment and future action plan will be carried out
- The Board considered the views and priorities of customers associated with the resilience of our service in developing the plan and commits to continuing engagement to inform the future action plan.

Cost assessment statement

Ofwat assurance requirement 1: Assurance that the expenditure forecasts included in the Company's Business Plan are robust and efficient.

The Board is satisfied that the expenditure forecasts included in the Company's Business Plan are robust and efficient.

- Expenditure forecasts have been derived at a granular level by cost category. Efficiencies have been driven from a bottom-up assessment of costs and an analysis of the scope to deliver efficiencies
- Costs have been derived at an activity/department level, based on the costs required to meet the obligations in the plan
- Executive directors have reviewed, challenged and agreed the costs for their areas of ownership
- Expenditure forecasts (both operating costs and capital investment) were regularly reviewed with Board involvement, including the impact of revised performance commitments on delivery costs
- The Board has also played a governing role in the Company's ongoing transformation programme, intended to make significant efficiency savings ahead of beginning to deliver the Business Plan from April 2020
- Independent forecasts were used to robustly assess real price effects on expenditure in a number of areas as appropriate. This included 'Forecasts for the UK economy' from HM Treasury for labour costs and a report on future energy costs from a consultancy specialising in energy market analysis
- Overall bill levels and refined efficiency assumptions included in the plan were reviewed and agreed at Board strategy days
- The Board secured further assurance with an independent third-party review of a comprehensive range of financial assumptions, covering a range of financial parameters including tax, that informed the final Business Plan
- The total cost of our plan is £286million, which includes making £21 million of efficiency savings between 2020 and 2025
- In response to the Initial Assessment we have updated the AMP7 totex based on the latest AMP6 forecasts and reviewed specific opex matters.

Ofwat assurance requirement 2: Assurance that large investment proposals are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers.

OFWAT ACTION SES.CA.A3 *- Produce a compliant Board assurance statement*

The Board is confident that the Company's investment programme is robust and deliverable, that a proper assessment of options has taken place, and that the options proposed are the best for customers.

- The Board has received assurance from the Executive that capital expenditure proposals are robust and deliverable and have been supported by the expertise of the company's supply chain delivery partners
- The Business Plan does not contain any single large investment proposals. The Board has been involved in decision making about the nature of our capital investment programme, particularly in relation to leakage reduction, trunk mains, the resilience programme and compulsory metering
- The Board's powers and delegation policy, which is formally reviewed each year in line with good governance practices, stipulates that any proposed budgeted spend over £250,000 requires Board approval

- No schemes have been assessed as suitable for direct procurement. Our entire capital programme is valued at less than half the threshold for assessment of Direct Procurement with the largest single scheme valued at £5.5million.

Risk and return statement

Ofwat assurance requirement: Assurance that the Board has identified the risks associated with delivering the plan.

Assurance that the risk mitigation and management plans the Board has in place are appropriate.

OFWAT ACTION SES,CA.A4 *- Compliant statement required*

OFWAT ACTION SES.CA.A5 *- Compliant statement required*

The Board has identified the key risks associated with delivery of the Business Plan and confirms that it has put in place appropriate risk mitigation and management plans.

- The Board has assessed and reviewed in detail the key risks to the delivery of our Business Plan and the mitigating actions as part of its strategic role in key decision making and signing off the finalised plan. Key risks were flagged by the Executive through formal monthly progress reports on the development of the plan prepared by the dedicated PR19 steering group
- All the scenarios prescribed by Ofwat and a number of company-specific scenarios, as well as combined scenarios, have been considered
- The Board confirms that there is adequate headroom for most plausible scenarios, and combinations thereof, through to 2030 but considers that additional headroom might be needed because the probability (albeit relatively remote) of more than one event or combination of events occurring increases with the longer time horizon being considered
- The Board has therefore obtained a signed undertaking from our two main shareholders – and the intermediate holding company Boards – of their intent to provide financial support in the scenarios described to ensure that we are able to continue financing our functions and deliver our commitments to customers
- The Audit Committee will continue to consider the operation of internal controls within the business and progress with management responses on detailed control points identified by external audit
- Included within our Annual Report is an overview of our principal risks, their impact and mitigations. Our risk register is reviewed by the Audit Committee on a 6-month basis with separate deep dives into specific risk topics at each meeting
- In January 2018 we produced ‘Looking Forward’, our long-term vision document which set the strategic context for our business plan and highlighted some of the key future challenges and opportunities for our business.

Financeability statement

Ofwat assurance requirement: Assurance that the Company’s Business Plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in both the short and the long term. The statement should clearly set out the steps taken to provide this assurance.

OFWAT ACTION SES,CA.A6 - *To provide a compliant Board assurance statement*

The Board confirms the plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in the short and long term. The statement should clearly set out the steps taken to provide this assurance.

- Since the September 2018 submission of our Business Plan we have carried out an assessment of financeablity against the notional structure adopted by Ofwat, in addition to reassessing against our actual structure
- We tested the plan against the financial sensitivities scenarios set out by Ofwat in their response to the 'Putting the sector in balance' consultation
- The PR19 financing committee, chaired by the senior independent non-executive director, provided updates to the Board on the financeability of the plan and it was a focus of Board strategy days
- We have significantly reduced our regulatory gearing level from c77% in March 2018 to c60% in March 2019, and have committed to maintaining our gearing below the levels that Ofwat deems reasonable throughout delivery of our Business Plan between 2020 and 2025. This is in line with Ofwat's expectations as set out in its 'Putting the sector in balance' position statement
- We publish a long-term viability statement in our Annual Report, the latest of which gives assurance for the period until 2025. Whilst we consider that we have adequate headroom for most plausible scenarios, and combinations thereof, through to 2030, the Board considers that additional headroom might be needed simply because the probability (albeit relatively remote) of more than one event or combination of events occurring increases with the longer time horizon being considered
- Therefore, the Board has obtained a signed undertaking from our two main shareholders – and the intermediate holding company Boards – of their intent to provide financial support in the scenarios described to ensure that we are able to continue financing our functions and deliver our commitments to customers.

Assurance statement

The Board confirms that, at its meeting on 27 March 2019, the full Board reviewed the Company's PR19 Business Plan resubmission, including the Board assurance statement, and approved its submission to Ofwat. We consider that the plan in the round proposes a package that meets our customers' expectations and will be well received by them.

Signed by:

Jeremy Pelczer, Chairman

Murray Legg, Senior Independent Non-executive

Dave Shemmans, Independent Non-executive

Jon Woods, Independent Non-executive

Seiji Kitajima, Shareholder Nominated Non-executive

Ryuichi Nishida, Shareholder Nominated Non-executive

Anthony Ferrar, Managing Director

Paul Kerr, Finance and Regulation Director