Our business plan 2020 to 2025

Response to Ofwat's draft determination on 30 August 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. In April 2019 we submitted updates to parts of our plan and provided further evidence in response to Ofwat's initial assessment. On 18 July 2019, Ofwat published its draft determination on our Business Plan.

This document and the associated appendices set out our response to Ofwat's draft determination and how we will ensure we deliver stretching improvements to our performance while delivering an efficient service that is affordable for all.

We accept the majority of interventions in Ofwat's draft determination. The package of performance commitments and Outcome Delivery Incentives (ODI) in the round provide strong incentives to drive upper quartile performance in many areas and appropriate protection for customers.

However, we are unable to accept certain aspects of the draft determination which fail to take into account or recognise the specific circumstances of our company and are, in part, not rational or reasonable in the light of the facts against which our Business Plan has been prepared and the guidance Ofwat is obliged to have regard to and take into account. It does not reflect the priorities of our customers within the overall objectives publicised and pursued by Ofwat.

Our Customer Scrutiny Panel has made its own independent representation to Ofwat, supporting the justifications we have made where we feel the draft determination does not reflect our customers' priorities. In their words, *"the CSP has taken the view that there are some valid concerns from a potential customer impact perspective that warrant us to share these with Ofwat."*

We are aware that other organisations, including the Environment Agency, have also submitted representations separately to Ofwat supporting our submission.

Delivering outcomes for customers

We accept the majority of interventions made by Ofwat relating to our performance commitments and ODIs.

In response to the draft determination we:

- Accept the changes to the leakage ODI subject to and conditional upon agreement by Ofwat that the appropriate level of enhancement funding is provided for delivery of this stretching commitment which builds on our strong performance comparative to the rest of the industry
- Accept the introduction of a softening performance commitment and an associated ODI, but recommend an alternative approach to the ODI proposed by Ofwat which reflects the nature of our softening activities and the effective impact that failing the target has on our customers
- Seek to reinstate the risk of supply failures performance commitment, with the associated ODI, subject to and conditional upon agreement by Ofwat that enhanced

funding is included to finish the final phase of our three-AMP network resilience programme.

We have revisited the willingness-to-pay research, undertaken as part of our customer engagement programme that underpins our plan, and provide further evidence of strong customer support for our proposed rate of mains replacement to sustainably reduce leakage for the long-term, as well as ensuring that every customer can be supplied by more than one treatment works.

Our representation case includes 25 performance commitments, 16 of which will be subject to a financial ODI with the total package containing 16 underperformance penalties and six outperformance payments. We consider this to be an appropriate balance of financial and reputational incentives on our stretching targets.

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, customer bills and our website. Our Board and Customer Scrutiny Panel will continue to monitor and challenge our performance to ensure we deliver our stretching targets.

Enhanced performance at an efficient cost

In our April 2019 Business Plan submission 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 £296 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).

The total expenditure allowance in the draft determination is 18.3% lower than we requested which equates to an overall cost gap of £54 million. This allowance does not support the delivery of outcomes to our customers and therefore the Board is unable to accept the feasibility of the draft determination position given that this would result in a significant overspend to strive to meet our stretching performance commitments.

Ofwat's draft determination provides £224.8 million of expenditure for wholesale activities. This is £43.6 million lower than the expenditure put forward in our April 2019 Business Plan submission, the majority of which is due to the disallowance of enhancement expenditure, including the cost adjustment claims for our leakage reduction and network resilience programmes.

In response to the draft determination we put forward representations for:

- £17.4 million enhanced expenditure for leakage which is critical to not just achieving a material reduction in leakage rates in AMP7 but also contributing to a sustainable journey towards more than halving leakage by 2045 by replacing more mains for longer term resilience. Our representation challenges Ofwat's current definition of upper quartile performance, where a true reflection of upper quartile would include us, as well as arguing that it should be based solely on a per property basis, which is more relevant in measuring actual leakage performance than per kilometre of main. The 15% reduction represents a significant improvement in performance from our already strong position and we consider that it will reinforce our upper quartile position, making us eligible for enhanced funding beyond what is included in base expenditure.

- £8.9 million enhanced expenditure for network resilience which is critical to ensuring that the remaining 44% of our customers (over 300,000 people) are protected from the risk of supply failures by being connected to more than one treatment works. This spend is in line with our 15-year resilience programme (already 80% completed) and to deviate from this long-term plan would be inconsistent with the results of prior price reviews and detrimental to our customers. Ofwat has invited us to, *"consider our assessment and present further evidence"* which we have done in our representation

- £10.5 million base expenditure for wholesale electricity usage which is critical to funding our energy consumption which is the highest in the industry due to how we have to abstract 85% of our water from deep underground. Our representation challenges Ofwat's econometric models which do not appropriately reflect uncontrollable items that impact companies' consumption and therefore costs. For example, we consider that Ofwat's proxy for electricity consumption, the number of boosters per length of main, does not adequately explain the variances in companies' power costs.

We will make £6.7 million of efficiency savings across our wholesale operations resulting in total requested wholesale expenditure of £251.6 million.

Ofwat's draft determination provides £26.7 million for residential retail activities. This is £10.7 million lower than the expenditure put forward in our April 2019 Business Plan. Through our ongoing and successful Customer Experience Transformation programme we are committed to making £2.1 million of further efficiency savings over the five-year period which has lowered our overall funding request to £35.3 million. However, in response to the draft determination we put forward a representation on our retail costs allowance which includes the following key arguments:

- Our projections for retail costs reflect tangible and deliverable business improvement initiatives to increase our operating efficiency in AMP7. We therefore do not consider that the significant gap between our cost projections and Ofwat's proposed allowances is a true reflection of our scope for efficiency improvement

- Funding the proposed scope of our retail activities in AMP7 (e.g. our local customer support centre) is strongly supported by our customers and not doing so would be in direct conflict with our customers' priorities

- Our cost projections set a strong efficiency challenge for us by the end of AMP7 that provides us with the time to implement our proposed operating performance commitments and bridge a proportion of the gap with Ofwat's modelled efficiency targets

- Further to the rationale we laid out in our April 2019 Business Plan, we maintain that Ofwat's approach to assessing retail costs is fundamentally flawed and while we accept all econometric models will have their limitations, the resulting judgements made on our retail costs are particularly concerning

- We have identified a number of improvements to Ofwat's retail cost modelling to increase the strength and validity of its evidence base which, when addressed, provide an increase in our allowed retail costs of £3.2 million compared to the draft determination.

Our total requested expenditure allowance in Ofwat's final determination is £287 million which is £8.8 million lower than our April 2019 Business Plan. This expenditure is required to deliver the stretching performance commitments we have made that are not adequately funded through Ofwat's draft determination and to ensure we deliver our customers' priorities.

Affordable for all

In its draft determination Ofwat increased the bill reduction over the 2020 to 2025 period from 4.9% in our April 2019 Business Plan to 15.3%, following the same profile as our plan with a larger reduction in the first year and then flat in real terms.

Our response to the draft determination results in a bill reduction of 7.7% which we believe strikes a reasonable balance between investment in long-term resilience, sustainable improvements to the service we provide and affordability for our customers.

Those in genuine financial hardship will be provided with additional support through our Water Support Scheme and we have committed to increase the number of people who receive it from 19,000 in our original plan to 25,000, at no additional cost to customers. We have a very strong track record of delivery in this area and ensuring bills are affordable for all continues to be a priority for us.

Ensuring long-term financeability

Ofwat expects companies to assure that they remain financeable on a notional and actual basis and that we can maintain resilience of our actual structure. Based on the representations in this submission being accepted for our final determination, the Board has reviewed and provided assurance on the financeability of our revised plan. This assurance has taken into account Ofwat's updated view of the cost of capital for the wholesale price controls (at 2.08% RPI deflated) and also the removal of our company specific uplift on our cost of debt (requested at 25 basis points).

We continue to be concerned about the wider effects of the declining cost of capital and strongly caution against a further fall at final determination, requesting that Ofwat takes a balanced assessment of the recent evidence available in reaching its view. Moody's has recently changed our outlook from stable to negative which is consistent with the current negative outlook on the UK water sector, but was strongly influenced by Ofwat's views on the lower cost of capital. We continue to disagree with Ofwat's disallowance of our requested company specific uplift, specifically Ofwat's view that there is no convincing evidence for compensating benefits to customers or customer support for the uplift, both of which we provided in our September 2018 and April 2019 submissions.

In light of previous concerns from Ofwat about highly geared companies, we proactively set out to achieve a better balance between levels of net debt and equity. Therefore, ahead of April 2020, we have already reduced our debt, allowing us to maintain gearing below the level considered appropriate by Ofwat to ensure longer term financial resilience.

Our September 2018 Business Plan was supported by a signed undertaking from our two main shareholders – and the intermediate holding company Boards – of their intent to provide financial support to increase our headroom in the unlikely event of extreme downside scenarios, to ensure that we are able to continue financing our functions and providing services to customers. The Board confirms that this signed undertaking still applies on the representation case we have made in response to the draft determination.

Based on the headroom available in our revised plan, the accompanying longer-term projections and the contingent support from our shareholders, we will be financially resilient through to 2030.

Confidence and assurance

As per previous submissions, elements of our representation have been independently assured by Mott MacDonald and EY. Our key arguments have also been reviewed by our legal advisors.

Ofwat has highlighted elements of our updated dividend and executive pay policies as industry best practice and we have provided further commitments, as part of developing both policies, to take account of other best practice identified and provide Ofwat with our finalised policies ahead of April 2020.

Navigating this document

There are four chapters aligned to Ofwat's test areas where we either provide a representation to an intervention, respond to an action or provide more information as part of our overall submission.

Chapter 1: Outcomes for customers – includes:

- A summary of our package of performance commitments and ODIs

- An overview of our representation cases for:

  Leakage

  Softening

  Risk of supply failures

- Affordability

Chapter 2: Cost efficiency – includes:

- Our response to Ofwat's intervention on the costs of delivering our plan

- An overview of our representation cases for:

  Wholesale electricity usage

  Retail costs allowance

- Our response to Ofwat's action on metaldehyde costs

Chapter 3: Risk and return – includes:

- Addressing Ofwat's interventions and actions in a number of areas including cost of capital, RoRE, gearing and Board assurance on financeability

- Our response to two long-term financial resilience actions

Chapter 4: Confidence and assurance – includes:

- Our response to Ofwat's actions on our dividend and executive pay policies, as well as independent tax forecast assurance

As advised by Ofwat we have not included chapters or narrative where we are accepting an intervention. For completeness, in the Appendix we have included a full list of all interventions and actions and for each one we have either indicated our acceptance or where a representation is being made. Our Company representation proforma signposts Ofwat to the exact chapter and page number of each intervention and action we are responding to.

CHAPTER 1

Outcomes for customers

Chapter 1: Outcomes for customers

We accept the majority of Ofwat's interventions related to our performance commitments and the associated Outcome Delivery Incentives (ODIs). We recognise that in the round they deliver stretching performance with the appropriate balance of financial incentives and will deliver more of what matters for our customers.

Section 1 of this chapter summarises our package of performance commitments and ODIs and how we have responded to the draft determination.

Section 2 sets out our representations in the following areas:

- Leakage: we accept the changes to the ODI made by Ofwat but only subject to and conditional upon the appropriate level of funding being included for delivery of this stretching commitment
- Softening: we accept the introduction of the performance commitment and an associated ODI, but put forward what we consider is a reasonable, fair and rational alternative approach to the ODI proposed by Ofwat
- Risk of supply failures: the risk of supply failures performance commitment was removed by Ofwat because funding for the associated resilience work was removed in our draft determination. We put forward a representation for why the funding should be allowed and why the performance commitment, and associated ODI, should be reinstated.

Section 3 confirms the affordability of our plan and the level of customers' bills.

Section 1: The overall package of performance commitments and ODIs

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 ODIs, which would enable us to achieve our five pledges and deliver great service to our customers. Our engagement on the acceptability of our draft plan showed that 76% of customers supported the planned activity and the impact this would have on their bill. It is important that through the various iterations of our plan, as part of the price review process, we continue to ensure that customer insight shapes what we plan to do to ensure we deliver more of what matters to them.

Ofwat's initial assessment of our plan, and then its draft determination, has made a number of changes to our original outcomes, the majority of which we have accepted. The key changes are highlighted below:

- We accept Ofwat's target for supply interruptions which is in line with projected upper quartile performance. Our Business Plan originally proposed a more stretching performance commitment as a safe, resilient supply of water was our customers' top priority. Achieving this outcome was also supported by the inclusion of a bespoke performance commitment to reduce the risk of supply failures through delivery of the last stage of our three-AMP network resilience programme. Our acceptance of the lower level of performance for supply interruptions was on the basis that the funding to deliver our resilience programme, and the associated bespoke performance commitment, would be included in our draft determination to enable us to deliver what matters most to our customers and we make a representation on this later in this chapter

- We accept two new performance commitments for water softening and in-year WINEP delivery
- Our performance commitment around increasing the number of customers on our Priority Services Register and regularly checking the data has been converted into a common performance commitment for all companies to attain
- Our perception of value for money performance commitment has been reinstated and includes stretching annual targets compared to our current target
- We accept the target for first contact resolution of 90% by 2025. This is stretching given our current performance for this measure is 76.7%. Our April 2019 Business Plan proposed an 8.3% uplift over the five-year period to reach 85% by 2025, which was based on a review of research by the Institute of Customer Service. We believe achieving this target will be extremely challenging due to the nature of the service we provide
- The majority of our performance commitments now carry a financial incentive – 16 include an underperformance penalty and only six have a potential outperformance payment.

The tables below set out our performance commitments (common and bespoke) following Ofwat's draft determination.

The highlighted commitments are those where we provide a representation to Ofwat's position on the performance commitment or where successful delivery of the performance commitment is directly linked to a cost efficiency representation.

Common performance commitments

Performance commitment	We will…	This means by 2025…	Performance commitment type
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
Supply Interruptions	Maintain our high upper quartile position	We will reduce to an average of three minutes lost per customer per year	Underperformance penalty and outperformance payment
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
Mains repairs	Continue our strong performance in reducing the number of mains that burst	We will reduce to 57.8 repairs per 1,000km of water main	Underperformance penalty
Usage - per capita consumption	Help customers reduce how much water they use	We will reduce the average amount of water	Underperformance penalty

		used by each person by 7.3% from 145 litres per day in 2019/20	
Unplanned outage	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
Risk of severe restrictions in 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
Priority services for customers in vulnerable circumstances	Increase the number of customers on our Priority Services Register (PSR)	At least 7% of our customers will be on our Priority Services Register and we will attempt to check 90% of our PSR data every two years	Non-financial
C-Mex: Customer measure of experience	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
D-Mex: Developer services measure of experience	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

Bespoke performance commitments

Performance commitment	**We will…**	**This means by 2025…**	**Performance commitment type**
WINEP delivery (per reporting year)	Deliver the agreed number of schemes each year, as defined by the Environment Agency	We will have delivered 24 river-based investigations and improvement programmes	Non-financial
River based improvement - delivery of WINEP	Deliver the requirements of the Environment Agency's Water Industry National Improvement Programme	We will have delivered 24 river-based investigations and improvement programmes	Underperformance penalty
Water softening	Continue to comply with our obligations to soften water at five treatment works	The average hardness of our water will not exceed 80mg of calcium per litre	Underperformance penalty
Customer concerns about their water (taste, odour and	Maintain our industry leading performance of having the fewest	We will receive no more than 0.5 contacts per 1,000 people about the taste, smell or	Underperformance penalty

discolouration contacts)	contacts from customers about their water quality	appearance of their water	
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	Underperformance penalty
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
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
Land based improvement – biodiversity	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 sites	Non-financial
Supporting customers in financial hardship	Increase the number of people who financially benefit from our social tariff	At least 25,000 customers will be on our Water Support Scheme	Underperformance penalty
Vulnerable support scheme awareness	Increase the awareness of our Helping Hand Scheme and Priority Services Register with all our customers	68% of our customers will be aware of extra support we can offer to those who need it	Non-financial
Vulnerable support scheme helpfulness	Ensure our Helping Hand Scheme and Priority Services Register are helpful to those that benefit from it	80% of customers will agree that the extra services they receive are helpful	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
First contact resolution	Reduce the number of times customers have to contact us about the same issue	90% of all customer contacts will be resolved first time	Underperformance penalty
Perception of value for money	Deliver value for money	No more than 6% of our customers will feel that their bill does not offer good value for money	Non-financial

In our representation we are also asking for the risk of supply failures bespoke performance commitment to be reintroduced, subject to the requested enhanced funding being provided.

Performance commitment	**We will…**	**This means by 2025…**	**Performance commitment type**
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

ODI incentive rates

The following table shows the financial incentive rates associated with our ODIs following Ofwat's draft determination. The highlighted ODIs are those where we provide representation to Ofwat's position.

Performance commitment	Underperformance penalty rate (enhanced underperformance rate)	Outperformance payment rate (enhanced outperformance rate)
Leakage	-£0.415m per Ml/day (-£0,467m per Ml/day)	£0.345m per Ml/day (0.467m per Ml/day)
Water softening	-£21,150 for every week a single site produces an average weekly hardness of above 80mg l/Ca	N/A
Supply interruptions	-£0.148m per minute/property/day (-£0.390m m/p/d)	£0.312m per minute/property/day (£0.362m m/p/d)
Risk of supply failures	-£72,516 per 1% of properties	£39,231 per 1% of properties
Water quality compliance	-£174,526 per unit of CRI	N/A
Mains repairs	-£26,524 per repair per 1,000km	N/A
Usage (per capita consumption)	-£0.415m per Ml/hh/day	N/A
Unplanned outage at treatment works	-£0.177 per 1% of capacity	N/A
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*
Customer concerns about their water	-£796,186 per contact per 1,000 people	N/A
Supporting customers in financial hardship	-£9.10 per customer	
Void properties	-£248,221 per 1% of properties	£248,221 per 1% of properties
First contact resolution	-£3,261 per 1% of contacts	N/A
Greenhouse gas emissions	-£1,578 per kilogram of Co2 equivalent per million litres of water put into supply	N/A
River based improvements – delivery of WINEP	-£4,390 per unit	N/A

*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.

Section 2: Representations to the draft determination – performance commitments and ODIs

For each of the representations made we set out the position at draft determination, how this differs from our previous Business Plan submissions and what we are asking for in our final determination. The basis for our representation is summarised and links to more detailed supporting evidence are provided.

Leakage

Draft determination position

The draft determination confirms our performance commitment to reduce leakage by 15% by 2025. It is subject to both a standard outperformance and underperformance payment and an enhanced outperformance and underperformance payment.

However, the cost adjustment claim submitted as part of our April 2019 Business Plan, intended to fund the step-change in activity to meet this ambitious target, was disallowed in full as Ofwat does not consider leakage reduction below the upper quartile to be enhancement expenditure and is therefore funded through base expenditure.

How the draft determination differs from previous submissions and assessments

In its draft determination Ofwat made the following interventions:

- Reduced the standard underperformance and outperformance rates
- Set an enhanced outperformance threshold
- Set an enhanced underperformance threshold
- Set enhanced rates for outperformance and underperformance
- Set an enhanced outperformance cap
- Changed the approach to calculating the unit cost of leakage enhancement and applying an efficiency challenge to those companies whose unit cost is higher than the industry median.

What we are now asking for

We accept the interventions to the ODI made at draft determination but only subject to and conditional upon Ofwat recognising that successful delivery of this performance commitment is subject to us receiving the requested enhanced funding of £17.4 million.

Basis of the representation

The 15% reduction represents a significant improvement in performance from our already strong position and therefore requires additional funding beyond what is included in base expenditure.

Ofwat set out at draft determination that only costs associated with reaching upper quartile performance would be allocated as ‘enhanced funding’. We challenge Ofwat’s current definition of upper quartile performance as well as arguing that it should be based solely on a per property basis, which is more relevant in measuring actual leakage performance than per kilometre of main. Requiring companies to perform above the upper quartile for both measures results in only three companies exceeding this and is therefore more demanding than the true upper quartile. If accepted, we would be the only additional company performing beyond the upper quartile for leakage per property and on that basis, we consider we should therefore receive enhanced funding.

In response to Ofwat's initial assessment of our Business Plan, in collaboration with eight other water companies, we commissioned NERA Economic Consulting ('NERA') to evaluate the approach taken to funding leakage reductions. This concluded that 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 compelling evidence that these assumptions are highly unlikely to be true and therefore proposes alternative approaches that Ofwat should take to ensure that an appropriate level of funding is provided to deliver our stretching performance commitment in this area. In its draft determination Ofwat has not acknowledged NERA's report and we therefore request that a full response to this evidence is provided by Ofwat as part of its engagement ahead of final determination to allow us to make further representation where required as the proposed alternatives present rational and reasonable solutions to deliver Ofwat's requirements.

We know that reducing leakage is a key priority for our customers - they support a significant reduction by 2025 and are supportive of contributing to the additional cost of delivering. Our draft Business Plan tested a 12% and 15% reduction and while the majority of customers wanted us to target 12%, 87% of customers supported us investing to deliver a 12% or greater reduction, and therefore 15% was chosen as a reasonable and deliverable target. To deliver this stretching commitment, while also creating a sustainable journey to more than halving leakage by 2045 as part of the industry's Public Interest Commitment, we need to replace 1% of our pipes each year. Our willingness-to-pay (WTP) research demonstrates that customers are prepared to accept an average annual bill increase of up to £4.70 to achieve this, whereas the actual cost to our customers each year will only be £4.44, £2.36 of this is funding the mains replacement element.

The Customer Scrutiny Panel (CSP) supports our representation and in their report submitted last September alongside our Business Plan, the CSP said, "*The company should continue to consider how it might reduce leakage further by 2025 and explore how it can use innovative approaches to achieve longer term leakage reductions in line with best practice."*

<u>Supporting evidence</u>

- Appendix A.DD.OC1 includes a report from NERA which provides the detail behind our representation
- Appendix A.DD.OC4 includes further willingness-to-pay analysis from expert market research providers Box Clever
- NERA's report on funding leakage reductions was included as Appendix A.CE3 of our April Business Plan
- Our cost adjustment claim for the mains replacement element of our leakage reduction programme was included as Appendix A.CE4 of our April Business Plan
- The CSP has made their own separate representation, particularly on the benefits of our proposed sustainable approach to leakage reduction for customers
- Other key stakeholders have also made representations on our case for leakage funding

Softening

Draft determination position

The draft determination introduces a new performance commitment and underperformance penalty associated with the delivery of our obligation to soften water at five of our water treatment works. The target is for calcium levels to not exceed 80 mg/l which will be measured by taking samples of treated water at the relevant treatment works. If the average weekly hardness at any of the five sites is above the target level, we face a penalty of £21,150 per week.

Ofwat also expects confirmation from the London Borough of Sutton, who holds the right to enforce our statutory softening obligation at two of our five softening sites, that they accept the 80mg Ca/l performance level.

How the draft determination differs from previous submissions and assessments

There was no performance commitment proposed in our September 2018 or April 2019 Business Plan submissions.

What we are now asking for

We accept the inclusion of a performance commitment associated with our obligation to soften water from five of our water treatments works. It links directly to the cost adjustment claim we submitted as part of our September 2018 Business Plan, updated in April 2019, which requested £12.1 million to deliver our statutory softening obligations as we are the only water company in England and Wales required to do so. In its draft determination, Ofwat has allowed £11.5 million of the funding requested, and we accept the efficiency challenge put forward.

Including a performance commitment associated with this softening activity will ensure that we continue to provide our customers with a high-quality service in this area, something that many of our customers believe is important. However, we do not accept the ODI that has been proposed and instead put forward an alternative which we reasonably consider better reflects the proper nature of our softening activities and the effective impact that failing the target has on our customers. We therefore propose what we consider to be a fair and rational approach, namely:

- Our performance should be measured using a quarterly average across our five treatment works
- The underperformance penalty should be scaled according to the amount by which the target has been missed
- The ODI should reflect the number of customers served by each treatment works by converting the revised quarterly penalty into a penalty per megalitre.

We consider that this approach will be a more effective and rational way of incentivising strong performance across all our treatment works. It is also better aligned with the detriment experienced by customers, should the target be missed.

Regarding confirmation from the London Borough of Sutton that they accept the 80mg Ca/l performance level, we are currently formally seeking this agreement in writing.

Basis of the representation

Our representation to the ODI is being made as we consider that the binary nature of the proposed penalty does not reflect the impact on customer experience or the economic consequences customers face if the target level is not met.

Water softness is not a binary measure – customers still benefit if water is softened to 81mg/l rather than 80mg/l as there is a positive linear relationship between softness and consumer benefits, such as savings associated with detergents and household appliances. Customers are affected by harder water but the impact of receiving water containing over 100 mg/l of calcium will be significantly greater than if they receive water containing 81mg/l of calcium. Therefore, the ODI proposed is inconsistent with Ofwat's guidance that underperformance penalties should compensate customers for losses associated with the company's failure to deliver performance commitments.

The water softening process is subject to fluctuations in calcium levels, due to variables such as raw water quality, so maintaining levels below 80 mg/l at all times will require us to target a consistently lower level, resulting in additional and unnecessary costs to customers. Targeting a lower level will also impact on our carbon emissions as they increase when calcium levels are reduced.

Ofwat's guidance also requires that underperformance penalties reflect the reduced costs that companies incur, given their underperformance. In the case of softening, this criterion is not met as we have a statutory obligation to partially soften water so will continue to incur costs even if the softening process results in higher than target calcium concentrations.

Finally, imposing the same penalty across our whole supply area does not account for the number of customers served or the amount of water treated at each site, which varies greatly and therefore implicitly imposes a different penalty on a per customer basis depending on where they live. Furthermore, our incentive to maintain or improve hardness in any particular area depends on performance in other areas.

Supporting evidence

- Appendix A.DD.OC2 includes a report from NERA which provides the detail behind our representation, including a proposed revised ODI and underperformance penalty, with a worked example
- Our updated cost adjustment claim for softening was included as Appendix A.CE2 of our April Business Plan
- The CSP has made their own separate representation, supporting our revised proposed ODI which they feel represents a sensible balance of penalty versus customer impact when the target is not met

Risk of supply failures – investment in network resilience

Draft determination position

The draft determination does not include the performance commitment to reduce the risk of supply failures. This is linked to Ofwat's decision to remove £8.9 million of enhanced funding from our plan for resilience due to insufficient evidence being provided to justify the need for this investment. Ofwat has invited us to, "*consider our assessment and present further evidence*" which we are doing in this representation.

How the draft determination differs from previous submissions and assessments

Our September 2018 and April 2019 Business Plan submissions included a bespoke performance commitment to reduce the risk of supply failures which was directly linked to the successful completion of our 15-year resilience programme, intended to ensure that 100% of customers can be served by more than one treatment works by 2025. Delivery of this performance commitment was subject to both an underperformance and outperformance payment.

<u>What we are now asking for</u>

We believe the performance commitment, with a financial ODI, should be reintroduced, subject to £8.9 million of enhanced funding being provided to complete the resilience programme.

<u>Basis of the representation</u>

We believe it right to include a performance commitment to incentivise delivery and protect customers. Our three-AMP resilience programme, already 80% completed, currently has an associated performance commitment and ODI. We put forward a representation that funding is included at final determination to enable us to complete this work by 2025. It will deliver a series of network enhancements to improve connectivity so our service to customers is more resilient to both short and long-term events, something which is a priority for our customers.

Once completed, we believe our customers will be the only ones in the UK to benefit from this level of strategic resilience, demonstrating upper quartile performance. This resilience will also contribute to increasing the connectivity of the wider region, being included in the modelling carried out by Water Resources South East (WRSE) as part of its regional resilience planning to identify future strategic water resources and transfers to make the region more drought resilient and protect the environment.

In its initial assessment of our Business Plan, Ofwat asked us and a number of other companies to provide an action plan to develop and implement a systems-based approach to resilience in the round and ensure we can demonstrate in the future an integrated resilience framework that underpins our operations and future plans, showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework. Our action plan has been submitted to Ofwat and as requested it has been taken into account in our response to the draft determination for our resilience investment proposal.

The target we have proposed is supported by our customers, having been directly tested through our qualitative and quantitative customer engagement. Not only do our 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. Additional analysis undertaken as part of our representation shows that customers accept up to an average annual bill increase of £5.64 to protect 100% of properties from the risk of supply failures, yet the most it will cost customers in any one year of the AMP is £2.60. Furthermore, our quarterly household customer tracker survey consistently shows that ‘continuous supply’ is the strongest driver of overall satisfaction.

The CSP supports our representation, due to the level of customer support for increased resilience, and hopes this important programme can be completed. In their report submitted in September 2018 alongside our Business Plan, the CSP said, “*The CSP agrees with the EA that we should be working proactively with WRSE to build new water infrastructure”* as well as, *"the CSP believes this performance commitment is effective in measuring resilience improvements."*

Supporting evidence

- Appendix A.DD.OC3 provides the detail behind our representation, including expanded semi-quantitative analysis on critical asset failure that is outside our control and the related specific elements of our Water Resources Management Plan (WRMP) which has now been published
- Appendix A.DD.OC4 includes further willingness-to-pay analysis from expert market research providers Box Clever
- Appendix A.DD.LR1 is our systems-based resilience action plan, submitted to Ofwat separately on 16 August 2019
- The CSP has made their own separate representation, supporting the reinstatement of this performance commitment and the associated funding required
- The Environment Agency has made its own separate representation, particularly supporting the increased regional resilience that this funding would allow
- Further details about the work involved to complete our programme can be found in the Wholesale chapter of our September 2018 Business Plan.

Summary of key representations

Representation area	Changes sought from Ofwat in our final determination
Leakage	Award of the £17.4 million requested in our cost adjustment claim to ensure that we can meet our ambitious target and sustainably reduce leakage for the long-term
Softening	Revised ODI and associated underperformance penalty aligned with our recommendation
Risk of supply failures	Reintroduction of the performance commitment with the revised ODI (which was included in the draft determination) and the award of £8.9 million to successfully complete our resilience programme

Section 3: Affordability

In our April 2019 submission we proposed that from 2020 the average bill for the following five years would be £207 (including inflation) which is a £16 reduction in real terms, despite increasing investment to £126 million to deliver the improvements that customers want to their service – more than £400 per household. We felt this provided a compelling deal for our customers and communities, allowing us to deliver a consistently high-quality service at a fair price now and well into the future. In its initial assessment of our plan, Ofwat confirmed there was sufficient and convincing evidence that our plan will improve affordability overall from 2020 to 2025.

Ofwat's draft determination cut average bills by 15.3% in real terms compared to the 4.9% reduction in our April submission and allows £24 million of investment in service improvements. This results in an average annual bill of £161. Our representation case puts forward an average annual bill of £179 (a reduction of 7.7%) which we believe strikes a reasonable balance between investment in long-term resilience, sustainable improvements to the service we provide and affordability for customers:

(17/18 CPIH deflated price, excludes £6 water support tariff)

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	AMP7 Average
Company Plan (Apr 2019)	£190	£182	£182	£182	£182	£180	**£182**
Bill Profile - before profiling	£190	£163	£163	£161	£159	£157	**£161**
Draft Determination	£190	£161	£161	£161	£161	£161	**£161**
DD Representation	£190	£184	£180	£180	£178	£175	**£179**

In our September 2018 Business Plan, we highlighted that ensuring bills are affordable for all, including those in financial hardship, continues to be a priority for us. Ofwat has stated in its draft determination that we made a commitment to fund, through shareholders, 6,000 additional customers beyond our proposed 19,000 performance commitment level, without impacting on overall customer bills. This is incorrect. Our commitment was to have at least 19,000 customers on our Water Support Scheme by 2025 and our shareholders committed to funding the scheme if we exceed our target, which has been the arrangement since we exceeded our 2020 target of 5,000 customers three years ago.

The target of 25,000 was not included in our September 2018 or April 2019 submissions. Although this level was tested with customers as part of our engagement programme, we set the target of 19,000 to off-set some of the bill increase driven by customers wanting us to go further to reduce leakage and usage. We considered this was an appropriate trade-off to maintain overall acceptability of the plan. This was on the basis that committing to support 19,000 customers is a very significant increase on the level of support currently offered, particularly given it is already one of the leading, most extensive schemes offered by water companies[1]. We have a very strong track record of delivery in this area, currently supporting nearly 11,000 people on our scheme, more than double the number of people we planned to during the current five-year period.

Nevertheless, we accept Ofwat's intervention and the proposed performance commitment level for each of the five years. Our view is that a reputational incentive would have been more consistent with the social commitment of significantly increasing the number of customers in financial hardship receiving assistance. However, we will accept Ofwat's requirement for a financial ODI on this performance commitment and trust that doing this, as well as ensuring that the higher target does not impact customer bills, is evidence of our pledge to provide our service at a fair price and offer help when it's needed. It is also part of our contribution to the industry's Public Interest Commitment to strive to end water poverty.

[1] 'Water For All' – Affordability and vulnerability in the water sector (2017-18), Consumer Council for Water

Section 4: Conclusion

In this chapter we have set out the interventions made at draft determination that we accept and the package of performance commitments and ODIs that we consider provide stretching targets and will deliver our customers' priorities. This includes:

- Accepting the performance commitment for softening but proposing an alternative ODI
- the reintroduction of a bespoke performance commitment for risk of supply failures – subject to £8.9 million of enhanced funding being secured
- acceptance of the leakage ODI subject to and conditional upon the appropriate level of funding being included.

This will result in the annual average customer bill falling by 7.7% to £179 per year.

The table below summarises the change in our Business Plan between September 2018 and our response to Ofwat's draft determination.

	September 2018 Business Plan	August 2019 draft determination representation
Total performance commitments	24	25
Financial ODIs	11	16
Non-financial ODIs	13	9
ODIs with outperformance payments	9	6
ODIs with underperformance penalties	11	16
Return on Regulated Equity (RoRE) range	-1.6% to 1.2%	-3.3% to 2.7%

In response to Ofwat's feedback we have carried out a re-assessment of the RoRE analysis which shows that the average return on regulated equity in our proposed plan is now 3.68% and there is still a degree of downward skew. More information on our analysis is included in Chapter 3: Risk and return.

We have included a further five financial ODIs and delivery of all our performance commitments are subject to a reputational incentive to deliver. We will report our performance to customers each year as well as continuing to engage with them on their priorities.

We believe that accepting the majority of interventions and the subsequent acceptance by Ofwat of our key representations - with associated funding - strikes the right balance for our customers by building on our already strong performance in the areas that matter most to them at a price they can afford.

CHAPTER 2

Cost efficiency

Chapter 2: Cost efficiency

This chapter addresses the £54 million cost efficiency challenge we received at draft determination. In it we:

- Commit to make a further **£8.8 million** of efficiency savings across both our wholesale and retail activities, which reduces the cost gap between our April 2019 Business Plan submission and the draft determination to **£45 million**
- Provide representations for why we consider the draft determination underestimates our efficient costs and provide a case for the following expenditure to be included at final determination:
  - **£10.5 million base wholesale electricity costs** which are unavoidably higher than the rest of the industry due to our need to abstract 85% of our water from deep underground and which is not adequately accounted for in Ofwat's model that uses the number of boosters per length of main which unfairly disadvantages us
  - **£17.4 million leakage enhanced expenditure** to allow us to achieve our 15% leakage reduction target and reinforce our position as an upper quartile performer
  - **£8.9 million enhanced expenditure for network resilience** to enable us to complete the final stage of our three-AMP strategy to ensure all our customers can be supplied by more than one treatment works
  - **£8.6 million retail expenditure** as this accurately reflects the cost of providing the local service our customers want, will allow us to invest in tangible business improvements and is consistent with a more robust and defensible interpretation of the industry-wide evidence on efficient costs
- Explain why we do not agree with the change of methodology for cost sharing
- Provide updated forecasts for grants and contributions
- Clarify the PAYG rate.

Section 1: Summary of our April 2019 submission vs the draft determination

In our April 2019 Business Plan submission 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 £296 million (gross wholesale totex plus retail costs). 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).

The draft determination has challenged our proposed costs when compared to other companies and the wider economy, suggesting there is a £54 million gap (including wholesale and retail business units) between the base and enhanced costs of everything that we planned to deliver and Ofwat's view of what is considered efficient. We have acknowledged and responded to the size of this gap and our further proposed cost reduction methods will deliver a further £8.8 million of efficiency savings - £6.7 million wholesale gross totex reduction and £2.1 million retail cost reduction.

Wholesale totex

In our April 2019 Business Plan we submitted three wholesale totex cost adjustment claims; below we summarise them and the draft determination position:

1. Costs related to softening (£12.1 million) – draft determination allowed £11.5 million accepting that the base modelled allowance does not include these costs
2. The mains replacement component of our leakage reduction programme (17.4 million) – rejected in full at draft determination
3. Wholesale electricity usage (10.5 million) – rejected in full at draft determination.

We accept the draft determination for softening costs and will make further efficiency savings in our softening operations.

Further evidence is provided in Section 2 of this chapter to support our position for our wholesale electricity claim.

Our plan also included £8.9 million of enhanced expenditure to deliver the final stage of our three-AMP network resilience programme which is currently 80% completed. In Chapter 1: Outcomes for customers, we make the case for why this expenditure should be included in the final determination, as well as the £17.4 million for our leakage reduction programme.

Residential retail

In our April 2019 Business Plan we presented our view of the required retail expenditure of £37.4 million (nominal prices) during AMP7. Ofwat has proposed a substantial reduction in our allowed retail expenditure, based on the results of its econometric modelling, which results in a £10.7 million (nominal prices) gap between the retail costs that we proposed in April and Ofwat's draft determination view of efficient retail costs. We commit to making a further £2.1 million of efficiency savings in retail and provide further evidence in Section 2 of this chapter for why £8.6 million of retail expenditure should be included in the final determination.

Delivering what matter most to customers

We have carried out a detailed review of the draft determination cost allowances, particularly the disallowance of our leakage and electricity cost claims. It is our view that they do not currently support the delivery of outcomes that meet the priorities of our customers. The Board is therefore unable to assure the feasibility of the draft determination position given that this would result in a significant overspend to strive to meet our stretching performance commitments and because it will not deliver what customers have told us they want. We challenge the approach to cost assessment applied for the purpose of calculating draft determinations in a number of areas. In this chapter, as well as in Chapter 1: Outcomes for customers and associated appendices, we provide additional evidence to support our expenditure requirements which we believe are justified.

Revised wholesale and retail costs

Table 1 below provides a summary of costs in our April 2019 Business Plan compared with Ofwat's draft determination. In responding to Ofwat's draft determination we have carefully reviewed our forecast spend requirements for both our wholesale and retail components during AMP7 to identify scope for further cost savings relative to our April 2019 forecasts. These savings are reflected in a revised representation view of our required costs, which is also presented in Table 1 below.

Table 1: Comparison of our April 2019 Business Plan submission and representation case to Ofwat's draft determination

Wholesale & retail price control	SES Water Apr BP view	Ofwat DD view	Scope & efficiency challenge		SES Rep View Changes	SES Water Rep View	Remaining gap to Ofwat DDs
	[1]	[2]	[3] = [2] – [1]		[4]	[5] = [1] + [4]	[6] = [2] – [5]
Wholesale price control							
Base costs	205.2	191.2	-14.0		-3.6	201.6	-10.5
Enhancement	53.1	23.7	-29.4		-3.1	50.0	-26.3
Gross totex (excluding third party costs)	258.3	214.9	-43.5		-6.7	251.6	-36.8
Third party costs	10.1	10.1	0.0		0.0	10.1	0.0
Gross totex (including third party costs)	268.4	224.9	-43.5		-6.7	261.7	-36.8
Grants & contrib. income	14.3	8.7	-5.6		-1.0	13.2	-4.5
Net totex	254.2	216.2	-37.9		-5.7	248.5	-32.2
Retail price control							
Retail costs	37.4	26.7	-10.7		-2.1	35.3	-8.6
Total costs (excluding third party costs)							
Wholesale + retail	295.8	241.6	-54.2		-8.8	287.0	-45.4

Note: Wholesale totex is in 17/18 prices, retail costs are in nominal prices. Wholesale base costs include the full amounts related to water softening expenditure: £12.1m for the April Business Plan view and £11.5m for the draft determination view and representation case view. We understand that Ofwat's view of grants and contributions (£8.7m at draft determination) will be updated to £13.2m for the final determination. However, we have not reflected this change in the table.

The combination of these savings and our proposed adjustments to Ofwat's view of costs, leave a gap between Ofwat's draft determination and our view of required expenditure in AMP7 of £45 million. In summary, we broadly agree with Ofwat's approach to estimating base wholesale totex, but not on the scope of activities assumed to be captured under base cost allowances, in particular the disallowed cost adjustment claim for wholesale electricity usage. We have submitted representations on our proposed enhancement expenditure, providing further evidence where possible.

We have identified further scope for efficiency savings in retail costs but continue to have concerns around Ofwat's approach to modelling retail expenditure and provide a representation on this issue. The reductions in our forecast costs for our representation position are the result of the planned focus of resources in AMP7 on adoption of new technologies and a new digital operating model to support improvements in our operating efficiency. Under our representation view of costs, we will be able to support the delivery of our stretching performance commitments to customers during the forthcoming price control period.

There remains a considerable gap between our representation view of efficient costs and Ofwat's draft determination. We have taken on board Ofwat's analysis and feedback, and have used the draft determination to apply a further challenge to our cost estimates, identifying £8.8 million of scope and cost efficiencies. Nevertheless, we believe that the evidence we set out in this chapter demonstrates that the majority of the remaining cost gap should be funded at final determination. The claims are for efficient expenditure requirements and are necessary to support our stretching performance commitments to our customers.

Some of the forecast costs for our representation position would be subject to adjustment through Ofwat's processes for assessing enhancement claims and special cost factor claims. For example, where Ofwat is not persuaded that costs subject to a 'deep dive' assessment process have been robustly estimated, it would currently apply an efficiency adjustment of 5%. We note that in accepting the results of Ofwat's base cost analysis we are implicitly agreeing with its calculation of the relevant efficiency factors. However, we assume that the efficiency factors will be recalculated for final determination. Furthermore, unless otherwise indicated we continue to believe that the enhancement and special cost factor claims we have submitted represent a robust estimation of efficient costs. We have therefore not sought to pre-empt the application of any efficiency adjustments to the cost claims included in this representation.

Ofwat's interventions

Below we list the specific interventions and actions included within the draft determination and summarise how we have responded to each.

Ofwat has made one intervention 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 the company to address areas of inefficiency and lack of evidence.*

We describe how we have responded to this intervention in Section 2: Delivering our plan – expenditure requirements.

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

SES.CE.A2: *Company to provide evidence to confirm DWI agreement with its submitted plans/revised undertakings and that no metaldehyde specific treatment costs are included in the requested allowance.*

In our April 2019 Business Plan we adjusted our planned expenditure as a consequence of the metaldehyde ban by reducing our operating expenditure by £0.066 million over the period 2020 to 2025. Despite the recent judicial review and the Government's decision to withdraw and review the decision made in December 2018 to restrict the sale and use of metaldehyde products, we believe that it is highly likely that the ban will still go ahead. Therefore, as per our April submission, we have not reintroduced the required additional operating costs back into our requested allowance and we will bear any risk if the ban does not go ahead and we are therefore required to reintroduce mitigations.

We submitted our draft metaldehyde undertaking to the DWI on 31 March 2019 and were sent an approved document on 5 July which we responded to with a signed copy on 22 July. However, due to the judicial review, the sign-off process for all companies' revised undertakings has now been put on hold so at the time of submission of this document we are unable to provide evidence of the DWI's full agreement with our revisions.

Section 2: Delivering our plan – expenditure requirements

This section provides our detailed response to the draft determination and our representations on wholesale and retail costs respectively.

Wholesale total expenditure

Table 2 below compares our April 2019 submission wholesale totex to Ofwat's draft determination and our representation case for wholesale totex. We have responded to Ofwat's challenge to some components of our totex claim, and have reduced our view of the costs required to deliver our plan by £6.7 million. In other areas however, we consider our April 2019 submission to represent efficient costs and provide further supporting evidence in this representation case. In total, a gross totex gap of £36.8 million remains between our representation view of efficient costs and Ofwat's draft determination on wholesale totex for AMP7.

Table 2 – Ofwat's draft determination compared to our representation case (wholesale) (£m, 2017-18 prices)

Wholesale price control	SES Water Apr BP view	Ofwat DD view	Scope & efficiency challenge	SES Rep View Changes	SES Water Rep View	Remaining gap to Ofwat DDs
	[1]	[2]	[3] = [2] – [1]	[4]	[5] = [1] + [4]	[6] = [2] – [5]
Base costs						
Water Resources						
Base (excluding power SCF claim)	18.2	22.4	4.2	4.2	22.4	0.0
Power (SCF claim proportion)	3.5	0.0	-3.5	0.0	3.5	-3.5
Total	21.8	22.4	0.7	4.2	26.0	-3.5
Water Network Plus						
Base (excluding power & softening SCF claims)	164.4	157.3	-7.2	-7.2	157.3	0.0
Softening	12.1	11.5	-0.6	-0.6	11.5	0.0
Power (SCF claim proportion)	6.9	0.0	-6.9	0.0	6.9	-6.9
Total	183.4	168.7	-14.7	-7.8	175.7	-6.9
Total base costs	205.2	191.2	-14.0	-3.6	201.6	-10.5
Enhancement						
Water resources						
Water frameworks directive	0.9	0.9	-0.0	-0.0	0.9	0.0
Total (before implicit allowance adjustment)	0.9	0.9	-0.0	-0.0	0.9	0.0
Implicit enhancement allowance adjustment	0.0	0.4	0.4	0.4	0.4	0.0
Total	0.9	0.5	-0.4	-0.4	0.5	0.0
Water Network Plus						
Leakage	17.4	0.0	-17.4	0.0	17.4	-17.4
Species	0.1	0.1	-0.0	-0.0	0.1	0.0
Lead replacement	1.7	1.7	0.0	0.0	1.7	0.0
Supply & demand	2.6	2.6	0.0	0.0	2.6	0.0
Metering	21.1	19.5	-1.6	-1.6	19.5	0.0
Resilience	8.9	0.0	-8.9	0.0	8.9	-8.9
Free & 'in the round adjustments'	0.4	0.5	0.1	0.1	0.5	0.0
Total (before implicit allowance adjustment)	52.2	24.4	-27.8	-1.5	50.7	-26.3
Implicit enhancement allowance adjustment	0.0	-1.2	-1.2	-1.2	-1.2	0.0
Total	52.2	23.2	-29.0	-2.7	49.5	-26.3
Total enhancement	53.1	23.7	-29.4	-3.1	50.0	-26.3
Gross totex (excluding third party costs)	**258.3**	**214.9**	**-43.5**	**-6.7**	**251.6**	**-36.8**
Third party costs	10.1	10.1	0.0	0.0	10.1	0.0
Gross totex (including third party costs)	**268.4**	**224.9**	**-43.5**	**-6.7**	**261.7**	**-36.8**
Grants & contrib. income	14.3	8.7	-5.6	-1.0	13.2	-4.5
Net totex	**254.2**	**216.2**	**-37.9**	**-5.7**	**248.49**	**-32.2**

Note: We understand that Ofwat's view of grants and contributions (£8.7m at draft determination) will be updated to £13.2m for the final determination. However, we have not reflected this change in the table.

We accept the efficiency challenge that Ofwat has set for wholesale base costs, resulting from the modelled efficient base for both water resources and water network plus components (i.e. *before* our special cost adjustment claims). While we consider there are limitations in the econometric models and the frontier shift assessment that Ofwat has used to derive our base cost efficiency challenge for PR19, overall, we anticipate meeting the stretching base cost efficiency challenge that Ofwat has posed. We welcome Ofwat's acceptance of the majority of our cost adjustment claim for softening costs (£11.5 million vs. our £12.1 million claim) although request changes to the associated softening ODI which is detailed in Chapter 1: Outcomes for customers.

We also accept Ofwat's draft determination of 'unmodelled costs' – i.e. business rates, abstraction charges and costs to meet the Traffic Management Act where applicable – Ofwat's draft determination of our assessment of third-party costs and the proposed reduction in the allowed funding of enhancement metering expenditure in AMP7.

However, we do not consider that Ofwat's disallowance of our cost adjustment claims for wholesale electricity usage base costs as well as our leakage and resilience programmes is reasonable, rational, fair or justified. We set out our representations on these issues below.

Representation to the draft determination (wholesale costs)

Base costs - wholesale electricity usage costs

Draft determination position

In the draft determination, the £10.5 million cost adjustment claim (taking the form of an ex-post modelling adjustment request) submitted as part of our re-submitted Business Plan in April 2019 was rejected in full, as Ofwat considers that base allowance provides sufficient funding.

How the draft determination differs from previous submissions and assessments

In its initial assessment of our Business Plan, Ofwat's econometric models did not appropriately reflect uncontrollable items that impact companies' costs, such as electricity consumption requirements, hence why the cost adjustment claim was submitted.

What we are now asking for

We would like Ofwat to review the additional evidence we have provided in this representation and re-consider our £10.5 million cost adjustment claim.

Basis of the representation

Power is a significant proportion of costs for all water companies. Our energy expenditure per property, however, is the highest in the industry due to the high proportion (85%) of water we must abstract from deep underground and our operation in an area divided by hills. While the unit cost of power is, to a degree, within management control via the procurement approach, our use of electricity for abstraction is unavoidable. Furthermore, Ofwat's preferred control variable for electricity consumption in its econometric models, the number of boosters per length of main, does not adequately account for variance in companies' power costs – particularly where that variance results from the need to abstract water from deep underground. As a result, our wholesale base costs are higher than Ofwat considers efficient.

In its draft determination Ofwat states that it has a, "*variable that to a degree controls for energy consumption*" in its models. However, we consider that Ofwat's proxy for electricity consumption, the number of boosters per length of main, does not adequately explain the variances in companies' power costs. In particular, it unfairly disadvantages companies, such as us, whose high power costs are driven primarily by abstraction from deep boreholes rather than pumping water around our distribution network. Boosters are only used across the distribution network so do not capture the energy used in abstraction. We believe that pumping head is a more appropriate measure of the intensity of energy usage that is not under a company's control. Using this variable would increase our modelled base costs by between £6 million and £14 million. Our cost adjustment claim of £10.5 million sits in the middle of this range.

Another reason given for rejecting our claim is that we are forecasting lower energy consumption between 2020 and 2025. However, this is not relevant to assessing the need for a special cost factor adjustment, especially given that we have, and will continue to buy power efficiently compared to the rest of the industry which is particularly strong performance given our small size.

Supporting evidence

- Appendix A.DD.CE1 includes a report from NERA which provides the detail behind our representation
- Our cost adjustment claim for electricity usage costs was included as Appendix A.CE1 of our April Business Plan.

Enhanced costs – leakage reduction and network resilience

Our representations on the mains replacement component of our leakage reduction programme and our network resilience programme are included in Chapter 1: Outcomes for customers. In summary:

- Ofwat has disallowed in full our funding request of £17.4m to deliver a step change in leakage reduction. We do not consider this disallowance is reasonable, rational, fair or justified. Our significant leakage reduction programme in AMP7 would not be funded through base costs and Ofwat's definition of upper quartile performance for leakage inappropriately disallows our enhancement expenditure
- We consider our proposed resilience enhancement expenditure of £8.9 million in AMP7 is fully justified to meet our performance commitments to customers and do not agree with the rationale of Ofwat's disallowance. The expenditure will fund an important final phase of a three-AMP investment programme, that will increase our resilience when managing critical asset failure and during extreme weather events such as drought.

Retail total expenditure

Table 3 below compares our April re-submission on residential retail expenditure to Ofwat's draft determination and our revised representation case.

Table 3 – Ofwat's draft determination compared to our representation case (retail) (£m, nominal)

Retail price control	SES Water Apr BP view	Ofwat DD view	Scope & efficiency challenge	SES Rep View Changes	SES Water Rep View	Remaining gap to Ofwat DDs
	[1]	[2]	[3] = [2] – [1]	[4]	[5] = [1] + [4]	[6] = [2] – [5]
Retail costs (before Rep Case efficiencies)	37.4	26.7	-10.7	0.0	37.4	-10.7
Digital strategy and central efficiency				-2.8		
Digital first depreciation				0.7		
Retail costs (after Rep Case efficiencies)	37.4	26.7	-10.7	-2.1	35.3	-8.6

In total, there is a £10.7 million gap (nominal prices) between the residential retail costs proposed in our plan and Ofwat's view of the efficient level of retail costs.

This is split between a catch-up and a modelled efficiency challenge and equates to a 28.5% difference which Ofwat gave early notice of in a public letter in early July 2019, intended to give us as much time as possible to consider our response to this challenge. While we have identified scope for a further £2.1 million savings in our expenditure forecasts in AMP7 (details below), we consider the level of unfunded residual retail costs in Ofwat's draft determinations is unreasonable, discriminatory, unfair and unjustified and we set out our representation case on this issue below.

Representation to the draft determination (retail costs)

Residential retail expenditure

Draft determination position

Ofwat has used econometric models to assess companies' retail costs and set an allowance for efficient retail expenditure. This is a departure from PR14 where retail cost allowances were set on an 'average cost to serve' basis. Ofwat has triangulated results from across its 'bottom-up' (where bad debt and other[1] retail costs are assessed separately) and top-down (total retail costs) econometric models to set the retail cost allowance.

To set its draft determination allowances, Ofwat uses an upper quartile efficiency target for retail costs. For its draft determination on retail costs, it has set the price control efficiency challenge by placing equal weight on the upper quartile efficiency benchmark derived from models using historical and forecast industry costs, i.e. 50:50 weight on:

- Companies' *historical* efficiency scores, calculated as the ratio of historical to modelled costs during 2013/14 - 2017/18
- Companies' *forecast* efficiency scores, calculated as the ratio of business plan cost forecasts to predicted values from the benchmarking models during AMP7.

This approach results in a £10.7 million gap (nominal prices) between our April 2019 Business Plan forecast and Ofwat's draft determination on our retail costs. The upper quartile efficiency challenge is more demanding in the forecast period as it reflects anticipated cost reductions built into the business plans of various companies within the industry. For example, some

[1] Other retail costs are defined as total retail costs, less bad debt and debt management costs.

companies have proposed a reduction in retail costs as high as 40% compared to current levels, reflecting efficiency initiatives to be delivered in AMP7.

How the draft determination differs from previous submissions and assessments

The retail costs we submitted as part of our April 2019 submission were largely unchanged from our September 2018 Business Plan as we challenged the robustness of Ofwat's modelling approach and cost drivers in this area. However, we reduced operating expenditure by £1.3 million by re-evaluating the efficiencies that will be delivered as a result of our digitalisation strategy. Our proposed retail costs were relatively stable over the period despite our expectation that we will provide services to around 5% more customers by 2025. This includes significant growth in metered customers, who are more costly to serve. We also proposed stable costs despite increasing our activity to support our customers, particularly those in financial hardship.

What we are now asking for

We set out below updated retail cost projections that set us a strong efficiency challenge by the end of AMP7, providing us with the time to implement our proposed operating performance commitments and bridge a proportion of the gap with Ofwat's modelled efficiency targets[2] in the following areas:

1. Our cost projections, which reflect *tangible and deliverable* business improvement initiatives to increase our operating efficiency in AMP7
2. Evidence that funding the proposed scope of our retail activities in AMP7 (e.g. our local customer support centre) is supported by our customers
3. Highlighting the significant limitations with Ofwat's retail cost assessment models and the approach it has used to set the efficiency challenge for retail costs.

We consider that our cost projections set a strong efficiency challenge for our retail business by the end of AMP7, based on a tangible transformational journey. We therefore request that Ofwat reviews the following additional evidence we have provided as part of our representation and re-considers our retail cost allowance for the final determination. Further detail supporting each point is provided below.

1. Our cost projections, which reflect *tangible and deliverable* business improvement initiatives to increase our operating efficiency in AMP7

Ofwat's modelled retail cost efficiency challenge reflects large cost reductions forecast by other companies in the sector, which may or may not be feasible to ever achieve in practice. There are considerable risks in using forecast cost data and retail models that:

- Are untested as the basis for setting an efficiency challenge for each water company within the industry
- Set an efficiency challenge without reference to the deliverability and specific proposals each company has made to reduce costs in the forthcoming AMP.

[2] Even though as we discuss below, we contest whether Ofwat's retail efficiency targets are justified given the significant limitations in the retail modelling it has undertaken.

Our Business Plan reflects a challenging but demonstrably deliverable target for efficiency improvement that is backed by new business initiatives and investment which balance cost reductions with maintaining customer experience and service levels.

Our Digital First strategy, which will see us focus resources in new technologies and a digital operating model, will reduce the requirement on our telephony, print and mail provisions by over 70% by 2025. This approach was not considered previously as we were still forming our Digital First strategy and associated timeline, and only commenced our Customer Experience Transformation (CET) programme - which will see us deploy new technology for customer relationship management and our initial digital offering - in January 2018. As a direct result of our ongoing CET programme we have already:

- Reduced our complaints by more than 40%
- Reduced our customer enquiries by more than 50% which are managed within a five-day service level
- Transitioned over 100,000 internal print and mail requests to our more efficient service partner
- Reduced our unwanted contacts by more than 30%
- Transitioned more than 11,000 housing association customers to be directly billed and serviced by us
- Moved more than 11,000 customers on to our Water Support Scheme compared to a target of 5,000 by 2020
- Achieved our highest ever qualitative SIM survey scores in 2018-19 and our highest ever league table position in the first quarter of the C-MeX shadow reporting year.

As our transformation programme concludes, we are prepared to digitise our business through our Digital First strategy. The core focus of this significant change will see us introduce new service offerings such as voice recognition billing, video and integrated chatbot account management, and an end-to-end digital user experience. While a shift to digital channel management will be essential in achieving our proposed cost efficiency level, providing the scope for cost savings over the course of AMP7, we acutely recognise the distinct risk in customer experience degradation if this is managed too forcefully by limiting our customers' channel of choice.

2. Evidence that funding the proposed scope of our retail activities in AM7 (e.g. the local customer support centre) is supported by our customers

We have carefully balanced the considerations set out above in identifying our final representation view of efficient retail costs for AMP7. In contrast, Ofwat's proposed allowance is based solely on econometric modelling that abstracts from:

- The context of our retail business, in particular the stated service priorities of our customers

- The practical initiatives we are putting in place to improve our operating efficiency but will take time to implement over the course of the price control.

Our business is designed to provide a breadth and depth of service our customers require and deserve from us, and are willing to pay for. This includes a local and knowledgeable customer contact centre with interconnected digital channels also available, striking a balance for our customers who require a more traditional engagement method and experience, compared with those who prefer to interact with us digitally and indirectly.

As we evidenced in our September 2018 Business Plan, our customers have told us they value our local contact centre and are willing to pay to keep it based in the area. They are also prepared to pay more to be served by a small company as they believe this offers a higher standard of service, amongst other benefits. We recognise that we could relocate our contact centre to another area to avoid these additional costs but our customers do not support this. We have consistently heard through our engagement that customers value being served by a local company and this means our employees need to be in the local area.

As illustrated below, we gave four main reasons for why our customers support our local contact centre and the potential additional costs this involves:

Figure 1 – Why our customers value our local contact centre

More information on each of these points is provided in Appendix A1.4 – Phase three small company research report – of our September 2018 Business Plan.

Our revised costs reflect this specific service delivery model which is not directly comparable with other companies' costs, nor their existing or future quality of service. We believe our proposed costs are efficient and these types of issues cannot be picked up through the mechanistic cost modelling that Ofwat has used for its draft determination.

3. Limitations with Ofwat's retail cost assessment models and the approach it has used to set the efficiency challenge for retail costs

We commissioned NERA Economic Consulting ('NERA') to evaluate Ofwat's retail econometric models to inform our response to Ofwat's draft determination. Their report highlights several significant limitations in the econometric models Ofwat proposes to use to set retail costs allowances.

In particular, NERA highlights that Ofwat has made a judgment that new and untested econometric models (for regulatory allowance setting purposes) with an extremely low statistical fit are deemed appropriate to assess the relative efficiency of water companies' (including our own) retail operations, and to set efficient retail cost allowances for PR19. NERA highlights several issues with Ofwat's approach:

- The use of econometric models with extremely low statistical fit is inconsistent with similar judgments Ofwat has made in other parts of the price control, notably in assessing the reasonableness of its growth modelling used in its initial assessment of business plans
- The statistical fit of Ofwat's models is comparatively low compared to others Ofwat and other regulators have used, indicating that they may be less reliable than econometric modelling used in other contexts. This is a concern given that the proposed models have not been used or tested before as the basis for setting efficiency challenges within the industry
- Despite the statistical limitations with its retail cost models, Ofwat assumes that the unexplained variation between our retail costs and a challenging upper quartile industry benchmark it uses, can be attributed only to inefficiency rather than other factors such as data error or omitted factors from the modelling that may explain the variation in costs across the industry.

In addition, NERA highlights that the resulting efficiency scores for our residential retail business, which lead to a considerable reduction in the price control allowed expenditure compared to our business plan forecast, reflect a subjective upper quartile efficiency target that continues to be set based on forecast industry data. This results in:

- An efficiency challenge for PR19 that places considerable reliance on large cost reductions that have been forecast by other companies, which it may not be feasible for them to achieve, or are ever delivered in practice
- A suggestion that there may be a structural change in the cost structure of the industry that invalidates the models as a means of assessing companies' efficiency in the forecast period in the first place.

Given these findings, we have significant concerns with Ofwat's retail cost draft determination and do not consider the significant gap between our cost projections and Ofwat's proposed allowances are a true reflection of our scope for efficiency improvement.

We would expect Ofwat to reconsider its retail modelling and investigate closely the reasons for differences in companies' costs (both historically and on a projected basis) to establish if the efficiency challenge it proposes for AMP7 is achievable and justified, given the:

- Scope of retail activities our customers have expressed support for (e.g. the local customer contact centre discussed above)

- The tangible business improvement initiatives we are already seeking to put in place during AMP7 (as discussed above).

NERA also considered possible improvements to Ofwat's retail cost modelling and methodology for setting cost allowances. Their report identifies a range of fundamental improvements which, when addressed, provide an increase in our allowed retail costs of £3.2 million, relative to the draft determination. NERA also recommends that Ofwat considers:

- Placing less emphasis on the least reliable elements of its retail cost modelling
- Setting a median rather than upper quartile efficiency target, in light of the limitations identified with Ofwat's modelling as summarised above and detailed in NERA's report.

We ask that Ofwat considers these proposed improvements carefully and responds as part of its ongoing engagement ahead of final determination.

Basis of the representation

Our cost projections set a strong efficiency challenge for our retail business by the end of AMP7 based on a tangible transformational journey.

Despite the issues we have identified with Ofwat's costs assessment approach, we have also identified a further £2.1 million of efficiency savings in our retail operations which has lowered our overall funding request to £35.3 million compared to £37.4 million in our April 2019 submission.

Our revised cost projections would, by the end of AMP7, close a considerable part of the efficiency gap that Ofwat has identified. We have set out above the tangible steps that the business would undertake to deliver these efficiencies. This reflects a transformational journey for the business, and one that we are confident will underpin lower costs into AMP8 and beyond. By contrast, Ofwat's retail cost allowance is based in part on projected initiatives elsewhere in the industry that are currently more hypothetical in nature.

A combination of further efficiencies and Ofwat's revised modelling would bring us materially closer together from a retail efficiency gap standpoint, enabling us to invest diligently in our retail operations while remaining incentivised to continue seeking further efficiencies for the benefit of our customers. Alternatively, we would be forced to deliver a limited service experience based upon superficial efficiencies, as identified through the application of predetermined and deficient cost assessment models, inclusive of the efficiencies proposed by other companies which may not materialise, all of which is in direct conflict with the output from our customer research and their priorities.

We believe Ofwat should take further account of the weakness in its evidence base supporting our cost reduction targets. Where regulators consider that there is scope for significant operating cost reductions it is not uncommon to apply a glide path towards the lower cost target. Our proposed transition to a lower cost base supports such an approach. We therefore believe that this should form the basis of our cost challenge in Ofwat's final determination, and have prepared our representation accordingly.

Supporting evidence

- Appendix A.DD.CE2 includes the report from NERA which provides the detail behind our representation, specifically regarding the econometric modelling impact on our cost assessment.

Section 3: Cost sharing

In the draft determination, the calculation of Ofwat's cost sharing rate has been based on the ratio of our view of costs in our September 2018 Business Plan relative to Ofwat's view of efficient costs. Ofwat has stated that for the final determination it will calculate its view of costs based on a 50% weight on our final cost proposal in our representation to the draft determination and 50% weight on our September 2018 Business Plan.

Ofwat has proposed to change the cost sharing rates it had proposed at the PR19 methodology stage for companies in the 110 – 120% bracket. Based on the September 2018 Business Plan vs. draft determination view of efficient costs, Ofwat has put us in the 115% bracket so the cost sharing rate for outperformance is 35% and underperformance is 65%. Based on the original sharing rates we would have faced 37.5% and 62.5% - i.e. the draft determination policy is tougher than the original PR19 methodology.

We do not agree with this change in methodology from a principles perspective as it is unclear what Ofwat's rationale is for changing its policy. Our representation view is that Ofwat should retain the sharing factors that were proposed in the PR19 methodology decision, updated as appropriate for final representations on costs and final decisions on cost allowances.

Section 4: Grants and contributions

For the draft determination, Ofwat derived an estimate of the provision for developer services costs out of its 'modelled base plus' allowance using a two-step process. Firstly, it ran econometric models with and without growth (capex) costs and used the difference between the two results as the estimate of our growth cost allowance. Ofwat then compared its estimate of growth cost allowance with our business plan forecast of growth costs and used the ratio as the efficiency rate applied to our proposed grants and contributions recovery.

Since the publication of draft determinations, Ofwat has clarified that it will take a different approach to final determinations, instead applying its modelled efficiency challenge on 'modelled base plus' costs to companies' proposed grants and contributions income forecasts. This updated forecast compared to our April 2019 Business Plan and Ofwat's original draft determination on grants and contributions is provided in Table 4 below.

Table 4 – Grants and contributions income (17/18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	AMP7 Total
April BP forecast	2.81	2.85	2.83	2.91	2.87	14.27
Ofwat DD	1.72	1.75	1.74	1.78	1.76	8.75
Ofwat revised DD view	2.61	2.65	2.63	2.70	2.66	13.24

We have accepted the proposed efficiency challenge for the base expenditure of our wholesale business and, therefore, also accept Ofwat's proposed approach to grants and contributions.

Section 5: Allowed revenues

We have proposed, as part of our representation, a series of adjustments to allowed wholesale and retail expenditure in AMP7. This has implications for other building blocks in the calculation of allowed revenues, including but not limited to:

- The recalculation of the allowed retail profit margin, if our representation view is accepted on retail costs
- Change in the adopted PAYG rate used to calculate allowed revenues (we propose that Ofwat uses the natural PAYG rate based on opex to calculate allowed revenues).

Section 6: Conclusion

We believe that we have responded appropriately to Ofwat's draft determination challenge in identifying and committing to a further £6.7 million reduction in wholesale gross totex and a further £2.1 million reduction in retail costs, relative to our April 2019 Business Plan. In this chapter and elsewhere we present a strong case in support of funding the remaining cost gap including:

- In wholesale base totex, £10.5 million of efficiently incurred electricity usage costs that are not captured by Ofwat's draft determination methodology

- In wholesale enhancements:
  - £17.4 million of expenditure to improve leakage performance and reinforce our position as an upper quartile performer
  - £8.9 million of expenditure to complete our three-AMP strategy to improve resilience to industry-leading levels by ensuring all of our customers can be supplied from more than one water treatment works

- In retail, £8.6 million of expenditure that better reflects the cost of providing the local service our customers want, allows us to invest in tangible business improvement initiatives and is consistent with a more robust and defensible interpretation of the industry-wide evidence on efficient costs.

CHAPTER 3

Risk and return

Chapter 3: Risk and return

Over the course of our September 2018 and April 2019 Business Plan submissions we have developed our package of incentives so that they align our company and investor interests with those of our customers. In this chapter we present further updates in relation to risk and return, taking into account Ofwat's feedback on our April 2019 submission and our representations in response to Ofwat's draft determination. We also address Ofwat's feedback on our long-term financial resilience.

In Chapter 1: Outcomes for customers and Chapter 2: Cost efficiency we have made a number of representations in key areas:

- Additions to the scope of activities funded where Ofwat has requested additional supporting evidence
- Further arguments in support of company-specific cost allowances
- Adjustments to the regime of performance commitments and Outcome Delivery Incentives (ODIs) applicable to our activities.

These representations entail important, well-justified and material changes to the draft determination in the interests of our customers.

This chapter focuses on assessing the risk and reward balance and financeability of our representation case and summarises how we have responded to Ofwat's interventions at draft determination.

Our Board has assured this representation case as financeable. Though it is more challenging than our April 2019 submission – as a result of more stretching performance targets and lower allowed costs – we are confident in our ability to deliver our revised plan with a high degree of financial resilience. This is despite the further reductions in the proposed cost of capital allowance, which we address in Section 2: Cost of capital.

We have underpinned our Board assurance statement by seeking further cost efficiencies and by carrying out financial analysis of stress test scenarios to understand the circumstances under which further action may be required to maintain resilience. This builds on the action we have already taken to reduce our gearing. A summary of the financial analysis that informs our view of financeability and financial resilience follows in Section 3: Financeability and long-term resilience.

In addition to stress-testing the resilience of our plan to downside risks, we have reviewed and incorporated Ofwat's guidance on assessing the range of potential Return on Regulatory Equity (RoRE) outcomes. The plan that we are putting forward in this representation, quite rightly, poses a significant challenge to deliver even baseline returns. Upside potential will require strong outperformance on our ODIs, while we are exposed to significant (and asymmetric) downside risks should we underperform. Section 4: RoRE, summarises our analysis.

Section 1: Addressing Ofwat's interventions and actions

Ofwat has made seven interventions related to aligning risk and returns, five of which we respond to in this chapter. The remaining two we have accepted. They are as follows:

SES.RR.A1: *We are intervening to apply our view of the sector cost of capital to the company's allowed revenues for draft determinations.*

We accept this intervention based on the sector cost of capital set out by Ofwat in its draft determination. We provide feedback on potential future changes in the sector cost of capital in Section 2: Cost of capital.

SES.RR.A8: *SES Water should consider whether any revisions to its RoRE risk range should be made in response to the draft determination.*

We have considered revisions to our RoRE risk range as part of this representation and Section 4: RoRE, summarises our analysis.

SES.RR.C1: *We are making a technical intervention to align PAYG rates to SES Water's stated approach of recovering operating expenditure for each year for each wholesale control.*

We have accepted this intervention in principle. We propose a further update to align PAYG rates to recover operating expenditure in our representation case, given that we propose further changes to allowed costs. The resulting PAYG rate is summarised in Chapter 2: Cost efficiency.

SES.RR.C3: *We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework.*

We have accepted this intervention as part of our general update of RoRE risk ranges. Where Ofwat has provided specific guidance on values to use in our RoRE risk ranges we have taken this into account. We have also updated our ranges for consistency with our representation case. We summarise our updated RoRE analysis in Section 4: RoRE.

SES.RR.C4: *We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination.*

We have considered revisions to our RoRE risk range as part of this representation. Section 4: RoRE summarises our analysis.

Ofwat has also identified one action related to aligning risk and returns:

SES.RR.A5: *Pursuant to action SES.LR.A4, we expect SES Water to confirm the level of gearing it expects to achieve on the basis of its actual structure and provide Board assurance to confirm how the financeability and financial resilience of the actual structure will be maintained in the context of our draft determinations.*

We provide further detail and Board assurance in Section 4: Financeability and long-term resilience. This includes confirmation of the level of gearing (both on a notional and on an actual basis) that we expect to achieve. In relation to this we note that our covenant gearing threshold is 80%, rather than 85% as indicated by Ofwat in its assessment in relation to this action.

In this chapter we also address two of Ofwat's interventions related to securing long-term financial resilience (originally included in the long-term resilience test area):

SES.LR.A4: *The company should provide further detail and Board assurance about its plans to maintain its long-term financial resilience in the context of our draft determination as* *referenced in action SES.LR.C1. We also note that the undertaking of financial support referenced by the company is in the form of a 'non-binding expression of intent'. We seek further assurance from the company's Board that this provides the support the company might require to maintain its financial resilience in extreme downside scenarios. In its future reporting, we expect SES Water to apply suitably robust stress tests in its long-term viability statements in 2020-25.*

We accept this intervention and provide further detail and Board assurance in Section 3: Financeability and long-term resilience.

SES.LR.C1: *We expect companies to provide further Board assurance, in their responses to the draft determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.*

We accept this intervention and provide further detail and Board assurance in Section 3: Financeability and long-term resilience. We provide comments on recent market data on the cost of capital in Section 2: Cost of capital.

Ofwat's actions and interventions span three main areas: cost of capital, financeability and long-term resilience, and RoRE. The following sections contain our detailed submissions in each of these areas.

Section 2: Cost of capital

We continue to be concerned about the wider effects of the declining cost of capital and strongly caution against a further fall at final determination, requesting that Ofwat takes a balanced assessment of the evidence available in reaching its view. Moody's has recently changed our outlook from stable to negative which is consistent with the current negative outlook on the UK water sector, but was strongly influenced by Ofwat's views on the lower cost of capital. This section first sets out our representation in relation to our request for a small company premium, before presenting our views on the evidence relating to the sector wide cost of capital.

Our April 2019 submission set out further evidence justifying the application of a small company premium to our cost of capital. This evidence addressed Ofwat's three test areas:

- Test area one assesses customer support
- Test area two assesses customer benefit
- Test area three assesses the level of the proposed adjustment.

Ofwat has accepted our view that our cost of debt differs from that of larger companies (i.e. our claim passed the third test area regarding the level of the proposed adjustment) but considers that we have provided insufficient evidence of monetised customer benefits and customer support.

We continue to disagree with Ofwat's disallowance of our requested company-specific uplift, specifically Ofwat's view that there is no convincing evidence for compensating benefits to customers or customer support for the uplift, both of which we have provided in our September 2018 and April 2019 submissions. We remain of the view that our proposed small company premium is well-founded and supported by customers. However, we have provided Board assurance of the financeability of our representation case taking into account Ofwat's disallowance of the small company premium.

We note that Ofwat has reduced its sector wide cost of capital estimate in the draft determination to 3.08% (on a CPIH-deflated basis; 2.08% on an RPI-deflated basis).

It has indicated that the latest market evidence indicates further falls in the cost of capital. This is due to three trends in the underlying data between 28 February and 28 June 2019:

- A fall in 15-year index-linked gilt yields, Ofwat's chosen benchmark for the risk-free rate, reduces its estimate of the risk-free rate by 55 basis points
- Ofwat's chosen benchmark index for the cost of new debt fell by 75 basis points
- Ofwat's estimate of the water sector unlevered beta fell from 0.29 to 0.26.

We accept that the first two of these naturally result from Ofwat's chosen approach to the cost of capital. However, were Ofwat to adopt the 28 June 2019 unlevered beta estimate of 0.26 (and the corresponding asset and equity beta estimates) as an input into its cost of capital determination we would consider this an unbalanced reading of the evidence.

Betas are a statistical measure estimated using two data series (company returns and stock market returns) that fluctuate significantly over time. There is therefore a degree of measurement error associated with any beta estimate. The unlevered beta additionally relies on estimates of gearing, which can also change over short periods of time due to reasons that may not be linked to proactive changes in a company's capital structure or changes in its exposure to risk. All of these factors mean that a beta estimate at a particular point in time is not necessarily representative of a company's underlying exposure to systematic risk. This has led other regulators, notably Ofgem, to consider taking a longer term view of beta.

In Figure 1 below we have reproduced Ofwat's evidence on unlevered betas for water companies from February 2015 to June 2019. This shows that an unlevered beta of 0.26 – as referenced in Ofwat's draft determination – would correspond to a low point in recent years. An estimate of 0.29, as indicated for Ofwat's draft determination, would be lower than indicated by the evidence throughout 2016-18.

Figure 1: Ofwat evidence on unlevered beta

Source: Ofwat, ‘PR19 draft determinations: Cost of capital technical appendix’, July 2019

Selecting either value as a point estimate would mean Ofwat setting aside evidence drawn from estimation windows prior to 2018. We do not believe that a swing in beta such as the 0.03 fall between the February and June data cut-offs reflects a genuine shift in the exposure of water networks to systematic risk. We therefore request that Ofwat takes a balanced view of the recent evidence in reaching its view on beta in support of final determinations.

Ofwat has also sought views on two alternatives to its approach to unlevering and re-levering its estimates of beta:

- Its current ‘Enterprise value approach’ uses a measure of gearing based on listed companies’ market capitalisation and book value of debt to unlever raw equity betas
- An alternative ‘Book value approach’ uses a measure of gearing based on listed companies’ book values of equity and debt to unlever raw equity betas
- A further alternative ‘Indepen approach’ adjusts the notional gearing assumption based on an assumed market-to-asset ratio premium of 10% to re-lever asset betas.

We do not believe either approach would improve Ofwat’s assessment of beta.

The ‘Book value approach’ essentially replaces the market value of equity with a book value of equity in the unlevering calculation. This is inconsistent with how practitioners generally think of gearing, which is assessed on the basis of equity market value. It also risks producing misleading conclusions regarding companies’ exposure to risk. A company’s market capitalisation reflects the value of its future cash flows. As these rise (fall) relative to the company’s outstanding debt obligations, the degree of financing risk that the company is exposed to will consequently fall (rise). Using a book value measure of gearing to unlever equity betas would mean that this effect is not reflected in estimates of beta.

Turning to the ‘Indepen approach’, we consider that it rests on an unjustified assumption regarding the expected performance of the notional entity. The premium that Ofwat considers of 10% implies that on a forward-looking basis a notionally efficient company would be expected to outperform price control determinations in perpetuity. We acknowledge that there is evidence of water companies exhibiting premia in the historic data. However, there is a wide range of sources for such premia, not all of which are applicable to the notional entity or expected to be repeatable in the future. Given the degree of challenge that Ofwat has sought to impose on the industry in PR19 we do not consider it plausible that a notionally efficient company could be expected to outperform to such a material degree. We therefore view Ofwat's unadjusted notional gearing assumption of 60% under the 'Enterprise value approach' as a suitable assumption for re-levering asset betas.

Section 3: Financeability and long-term resilience

Ofwat has noted that it expects companies to provide further Board assurance, in their responses to the draft determinations, that they will remain financeable on a notional and actual basis, and that they can maintain financial resilience of their actual structure. The Board has reviewed and provided assurance that the Company will remain financeable based on our response to the draft determination, inclusive of the representations made within this response to the draft determination. That includes our view of the cost allowance and efficiencies, together with the performance commitments and associated ODIs, as represented in this response document. This section summarises the analysis on which the Board's assurance of financeability is based.

We have tested the financeability of our representation submission based on the same approach we applied for our April 2019 submission, updated to reflect Ofwat's draft determination and our representations. We have forecasted key financial ratios used by the credit ratings agencies on both a notional and actual balance sheet basis, and also tested whether our projected financial ratios were consistent with the covenants on our £100 million index-linked bond, which we took out in 2001 and expect to redeem in 2031. The financial ratios used in the covenant tests are different to those used by the credit rating agencies, but remain in line with those referred to in our April 2019 submission.

The forecast ratios for AMP7 based on our actual structure are shown in Table 1 below.

Table 1: Forecast credit and bond ratios for AMP7 (actual structure)

Moody's Credit Ratios	Baa Criteria	2020-21	2021-22	2022-23	2023-24	2024-25
Adjusted Interest Coverage Ratio	1.5-2.5x	2.3x	2.4x	2.4x	2.5x	2.5x
Gearing	55-70%	69.1%	70.0%	70.7%	70.7%	70.3%
FFO/Net Debt	10-15%	13.8%	13.6%	13.7%	14.2%	14.5%
Bond Ratios	**Criteria**	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**2024-25**
Interest Cover Ratio (ICR)	> 1.3	1.89	1.88	1.87	1.87	1.88
Adjusted Interest Cover Ratio (AICR)	> 1.0	1.00	1.00	1.00	1.00	1.00
Regulatory Asset Ratio (RAR)	< 80%	73.1%	74.7%	75.5%	75.7%	75.9%

Due to our financial structure, AICR has always been the tightest bond ratio. As for our previous submissions, it remains just above the covenant threshold of 1.0 throughout AMP7, but can be managed by additional borrowing to increase cash inflow. By complying with the covenant ratios, we will have sufficient headroom on the ratios referred to by credit rating agencies.

In response to the concern raised by Ofwat in action *SES.RR.A5* - using further debt as a mechanism to manage covenants does not have a negative impact on other financial ratios and financial resilience during the period covered by our modelling. On the contrary, additional debt can be used to manage AICR as needed, and our recent de-gearing exercise to reduce overall levels of debt in the Company has therefore allowed us to maintain appropriate gearing levels for longer term financial resilience.

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. Under the updated Business Plan based on the representations made in this document, the minimum amount of 'headroom' in each year of AMP7 will be c.£13 million. Our regulatory gearing is forecast to be c.70% on average over AMP7, and to be on a stable trend throughout AMP7.

To gain assurance on long term financeability in our response to the draft determination, we retested a variety of Ofwat prescribed and company-specific scenarios, outlining the additional debt we can raise (while staying within our gearing covenants) and therefore the remaining headroom. This analysis has informed our understanding of both the circumstances under which additional financial solutions may be required and the magnitude of those solutions. Table 2 below summarises the results.

Table 2: Scenario analysis for AMP7

	Headroom (£m)	
	AMP7	AMP8
Base Case - DD Representation	13.4	11.5
(Base Case - April 2019 BP)	16.7	16.6

(£m, in outturn prices)

	Ofwat's Prescribed Scenarios	Impacts		Additional Debt		Remaining Headroom		Further Funding Solution	
		AMP7	AMP8	AMP7	AMP8	AMP7	AMP8	AMP7	AMP8
1	10% Totex overspend over 5 years	- 29.6	- 29.7	+ 30.6	+ 28.4	No Headroom		+ 18.0	+ 26.0
2	ODI penalty (3% of RoRE) in 1 year	- 2.5	- 2.8	+ 0.5	+ 3.1	11.8	7.8	-	-
3	1% inflation increase over 5 years	+1.0%	+1.0%	+ 6.6	+ 7.4	14.0	11.1	-	-
4	1% inflation decrease over 5 years	-1.0%	-1.0%	- 9.5	- 5.9	18.7	20.0	-	-
5	5% increase in bad debt over 5 years	- 0.1	- 0.1	+ 2.8	+ 10.7	13.9	12.1	-	-
6	2% increase in interest rates	- 5.1	- 6.3	+ 4.0	+ 7.4	8.4	2.8	-	-
7	Penalty (3% of revenue) in 1 year	- 2.0	- 2.3	+ 0.5	- 0.2	11.1	10.0	-	-
8	Intercompany Financing Scenarios	-	-	-	-	-	-	-	-
9	Combined Scenario	- 37.1	- 37.6	+ 38.5	+ 37.2	No Headroom		+ 25.0	+ 35.0

	Company Specific Scenarios	Impacts		Additional Debt		Remaining Headroom		Further Funding Solution	
		AMP7	AMP8	AMP7	AMP8	AMP7	AMP8	AMP7	AMP8
1	Cyber attack fines - 4% of Turnover	- 2.8	- 3.2	+ 4.0	+ 4.4	9.2	4.6	-	-
2	Water Quality Failure	- 6.4	- 7.1	+ 5.6	+ 7.4	7.7	0.0	-	-
3	Loss of high quality staff	- 2.6	- 2.8	+ 2.0	+ 3.7	11.3	6.7	-	-
4	OPEX underperformance - Historical	- 4.1	- 4.2	+ 3.8	+ 10.7	9.6	0.6	-	-
5	AMP6 Efficiency Programme failure	- 15.7	-	+ 16.0	+ 0.9	No Headroom		+ 5.0	+ 0.0
6	Bond Sinking Fund waiver requirement	- 4.2	-	+ 3.6	+ 1.0	9.4	7.9	-	-
7	Pension costs on DB scheme	- 7.2	- 6.4	+ 6.2	+ 7.9	7.1	1.0	-	-
8	Redemption costs for Index Linked Bond	-	- 2.0	- 0.8	+ 2.7	14.1	10.2	-	-
9	Combined Scenario (No.1 & 4 & 5)	- 22.5	- 7.3	+ 23.7	+ 1.2	No Headroom		+ 11.0	+ 3.5
10	Regulatory WACC Reduction (1.71%)	- 5.7	- 8.1	+ 5.2	+ 7.7	8.1	2.2	-	-

(*) 'Remaining Headroom' represents the minimum amount of headroom within each year of the AMP

The results are similar to those included in our April 2019 submission. There is headroom on all scenarios except the two of the Ofwat prescribed scenarios (10% totex overspend over five years and Ofwat's combined scenario), and except for two of the company-specific scenarios (a failure of our AMP6 efficiency programme and our combined scenario). There is only one scenario – relating to 'AMP6 efficiency programme failure' in our company-specific scenarios – that would require us to take action under this representation submission, that would not have required action under our April 2019 submission. In scenarios where no headroom exits, we would need to suspend dividend payments or inject additional equity.

We confirm that we have specifically tested – in our company-specific scenarios – the further downward pressure on the cost of capital by a reduction of regulatory WACC to 1.71%. Notwithstanding our concerns regarding the use of a WACC estimate as low as 1.71%, we confirm that there is sufficient headroom to manage a downside scenario of this magnitude, though clearly not if included within our specific combined scenario.

Ofwat noted our undertaking of financial support from our two main shareholders and has sought further assurance from the Board that this provides the support the company might require to maintain its financial resilience in extreme downside scenarios. The Board confirms that this signed undertaking from our shareholders will provide financial support in the event of an extreme downside scenario, based on the analyses above and on the representation case made within this response to the draft determination. That includes the representations we have made on performance commitments, ODIs, cost allowances and efficiencies within this response document.

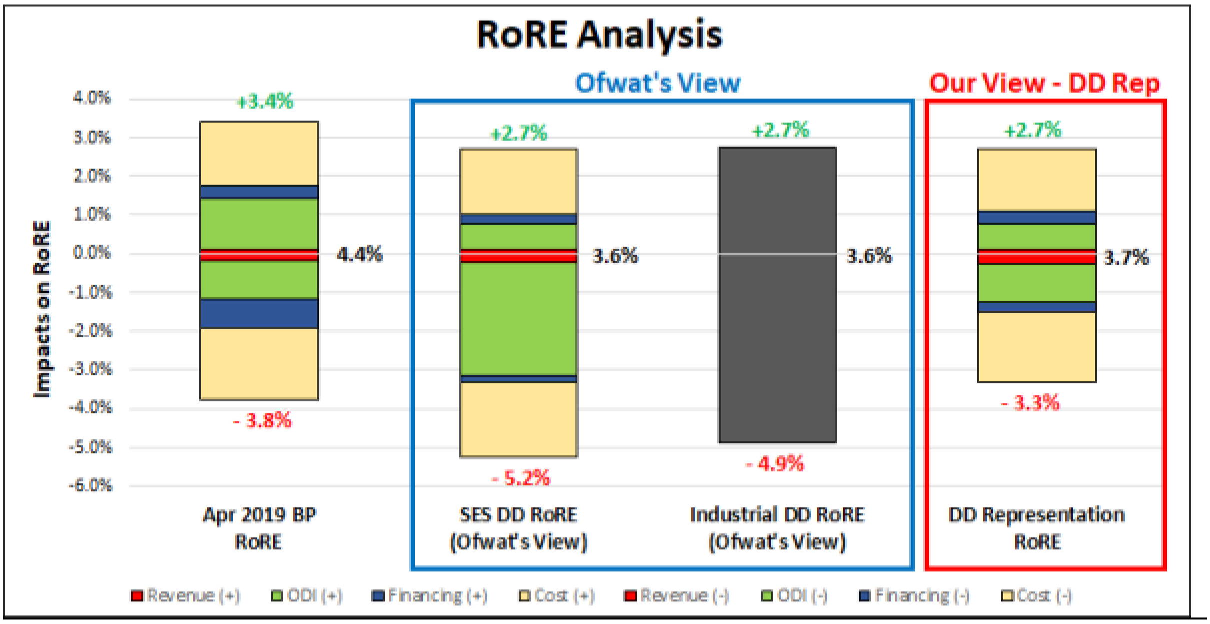
On the basis of the assessment of potential calls on the headroom we have available within our plan, and the accompanying longer-term projections, together with the contingent support we have from our shareholders, we will be resilient on our planned capital structure (and by implication on the notional 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.

We also confirm – as requested by Ofwat – that in future reporting we will continue to apply suitable robust stress tests in our long-term viability statement throughout 2020 to 2025.

Section 4: RoRE

In response to Ofwat's feedback we have carried out a re-assessment of the RoRE analysis. This analysis includes updated base cost of capital assumptions, updated PCs and ODIs, and updated assumptions for risk-ranges around the base case. We note that our risk-ranges around the base case for ODIs based on updated P10 and P90 assumptions supports the use of a 3% ODI penalty in one year as a downside stress-test scenario. The updated analysis shows that the average return on regulated equity for the appointed business as a whole in our proposed plan is now 3.7%. Figure 2 below presents our updated analysis of the range of RoRE outcomes around this base case.

Figure 2: RoRE range analysis



There remains a degree of downward skew in our RoRE range. We have identified four reasons why this downward skew is consistent with the overall package of cost allowances and incentives, in the context of expected performance delivery, past performance and steps taken to deliver on our plans and mitigate against downside risks:

- Of our 16 financial ODIs, 10 are penalty-only and a further six have penalty rates that exceed the reward rates. Other things being equal, a given level of underperformance would drive more significant financial consequences than an equivalent level of outperformance
- In some areas of performance, notably leakage, there are operational constraints on upside outperformance potential that are not mirrored by constraints on downside risks
- Analysis of our own historical totex data suggests that we are more likely to overspend (underperform) than to underspend (outperform) against Ofwat's allowances
- As Ofwat has noted, latest market evidence indicates that a further reduction in the allowed WACC currently appears more likely than an increase.

We therefore continue to view our modelled RoRE range as being consistent with the overall design of the price control package. Although our view of potential outperformance is in line with Ofwat's draft determination view, our view of potential underperformance – particularly on ODIs – is less extreme. We are not aware of Ofwat's specific performance level assumptions that drive this difference, but consider that our April 2019 Business Plan submission P10 and P90 assumptions, on which Ofwat did not intervene, largely remain appropriate.

Conclusion

In this chapter we have set out the Board's view that the Company will remain financeable based on our response to the draft determination, inclusive of the representations made within this response to the draft determination. This is based on a careful stress-testing of our credit rating and bond ratios and borrowing capacity under a range of Ofwat prescribed and company specific scenarios.

We have noted Ofwat's reduced draft determination WACC estimate, and have used this figure as the basis for our financeability testing. We continue to disagree with Ofwat's disallowance of our requested company-specific uplift and have reservations about further potential downward pressure on the WACC. We note that Ofwat's approach to ODIs – in particular the number of penalty-only ODIs and penalty rates that are generally higher than reward rates – produces a downward skew in our RoRE range. As noted above, we have however, questioned the P10 assessments that are used to produce Ofwat's draft determination downside view of -5.2%.

CHAPTER 4

Confidence and assurance

Chapter 4: Confidence and assurance

While Ofwat has not issued any interventions in this area, we have been asked to take further action on our dividend policy, executive pay policy and tax forecasts assurance.

Section 1: Addressing Ofwat's actions

Dividend policy

SES.CA.A7 We expect SES Water to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies.

Our agreed dividend policy for 2020 to 2025 will demonstrate that we will take account of obligations and commitments to customers and other stakeholders, including consideration of performance delivery against the final determination.

In our response to Ofwat's initial assessment of our Business Plan, we updated our dividend policy to ensure it is more transparent and accessible, and in line with Ofwat principles to put the sector in balance. We note that Ofwat has highlighted our approach on transparency and explaining the Board's decision-making as best practice and we will ensure that this is complemented with clear explanations of the dividends that are paid and how they relate to our performance, to our customers and stakeholders. The Board will explain the way in which factors have been taken into account in arriving at the dividend declared in our Annual Report and other publications, including any quantitative analysis which is required to meet financial and regulatory reporting standards.

We have considered the other examples of best practice as identified by Ofwat and will incorporate the following into our revised policy:

- Performance levels and expectations – we will reiterate in our agreed dividend policy for 2020 to 2025 that the Board will consider any variations from the 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.

- Meeting obligations and commitments to our customers – we will expand our agreed dividend policy for 2020 to 2025 to ensure it is clear on the factors that need to be met in order to pay dividends above the stated level of base dividends (which we have defined as the return on regulated equity allowed in the most recent price reviews, subject to the Company having adequate resources available to fulfil its overall service commitments and its other financial obligations)

- Details on specific obligations and commitments – we have noted Affinity Water's diagrammatic approach to explain their dividend policy, which reiterates the assessments we have summarised in narrative format, in terms of customer service, performance and statutory and regulatory obligations. We will develop a comparable illustration to clearly explain our dividend policy as part of our transparency commitment to customers and ensure that this is included in our Annual Report and other communications as appropriate.

Final decisions on our dividend policy for 2020 to 2025 will be made at our February 2020 Board meeting. Following this we will update Ofwat and signal the changes to our stakeholders ahead of 1 April 2020 when the new policy takes effect.

Executive pay policy

SES.CA.A7 There remain a number of details to be finalised, for example the final details of the underlying metrics and weightings. Once finalised, we expect SES Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance: position statement'. We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25. We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.

The Board fully agrees with Ofwat's expectations with respect to companies being transparent about how executives are remunerated and ensuring that the performance-related executive pay policy demonstrates a substantial link to performance delivery for customers.

In our April 2019 submission, the Board confirmed the Remuneration Committee is in the process of enhancing and updating its executive pay policy and set out the factors being considered. The final details of the underlying metrics and weightings of the policy, related to the final determination, will be agreed at the Committee's meeting in February 2020, allowing us to make direct reference to approved performance commitments and defined financial metrics. We believe this is key to both ensuring the strongest possible link between executive pay and our performance and that the policy is based on appropriately stretching benchmarks.

As part of our ongoing work to update our policy, we have considered the examples of best practice as identified by Ofwat and will incorporate the following into our revised policy:

- Substantial delivery for customers – the majority of incentives for performance-related executive pay will be linked to delivery for customers, including operational performance areas that we know are particularly important to our service levels

- Stretching targets – executive pay performance metrics will be aligned to our final determination and factors such as year-on-year improvement and industry position will be considered as part of agreeing our updated policy. The Board will ensure any outperformance is only payable if we are earning a net reward for the delivery of our customer pledges in any one year. This will be particularly stretching given our targets for 2020 to 2025 are typically in the industry upper quartile

- 'Gateway' and 'underpin' arrangements – we already have an executive pay gateway arrangement in place and have done for a number of years which will continue in our updated policy to ensure that financial performance is not prioritised over outcomes for customers

- Remuneration Committee discretionary powers – as noted by Ofwat, our Remuneration Committee already has the discretion to reduce in full or part any bonus payments for exceptional circumstances (such as major reputational issues including a significant safety incident or water restrictions) and this arrangement will continue.

Through our Remuneration Committee we are committed to reviewing our executive pay policy annually, to include continually stretching targets, and where it changes, we will explain the reasons in our Annual Report and signal changes to stakeholders.

Following the Remuneration Committee in February 2020 we will inform Ofwat of our updated policy, ahead of 1 April 2020 when it takes effect.

Tax forecasts

SES.*CA.A11 SES Water is required to provide further evidence to explain the assurance process it has taken to develop its tax forecasts. Should the company not provide sufficient evidence in advance of the Final Determination, we will consider whether it is appropriate to make an adjustment to the tax allowance in the Final Determination to reflect this*.

We commissioned EY to review our underlying tax forecast assumptions and provide commentary on the following areas:

- The process we have undertaken in preparing our tax assumptions
- The reasonableness of our assumptions, particularly regarding capital allowance and interest deductibility
- The reflection of our assumptions in Ofwat's model.

Please see Appendix A.DD.CA1 which further explains the assurance we have undertaken and EY's conclusions.