

19 September 2014



Severn Trent Water Limited

Sonia Brown  
Chief Regulation Officer  
Ofwat  
21 Bloomsbury Street  
London  
WC1B 3HF

Severn Trent Centre  
PO Box 5309  
Coventry  
CV3 9FH

Tel 024 7771 5615

[www.severntrent.com](http://www.severntrent.com)  
[www.stwater.co.uk](http://www.stwater.co.uk)

Dear Sonia

### Approach to the Draft Determinations

I am writing to you to suggest a way in which we might approach our response to the recent Ofwat Draft Determinations (DDs), in order to help ensure an effective process, which focuses on the critical issues – and gives us the best chance of delivering the best possible outcome for our customers.

We have been very supportive of the way in which Ofwat has developed the approach to this price review versus previous reviews, particularly in relation to the transparency of the approach and constructive dialogue. We too have been keen to maintain a very open and constructive dialogue during the review process.

We appreciate that Ofwat has all 14 “slow track” DDs to complete in only a matter of weeks, and there remains a number of significant issues to be finalised, during the final stage of the price review process. Given the time available and the fact that we have a small number of issues that are absolutely critical to us, documented below, we have come to the conclusion that focusing our representations on a relatively small number of material issues to Severn Trent, rather than challenge across a wide range of individual issues, allows sufficient air time for our critical issues and demonstrates our commitment to a constructive dialogue. This would include:

- **The Elan Valley Aqueduct (EVA): Birmingham resilience** - where we have undertaken the additional work required by Ofwat in the DD to justify the inclusion of the revised cost of the scheme, including the additional Board assurance.
- **The EVA: community risk schemes** – where the work we have undertaken with the Health and Safety Laboratory to revise our cost benefit assessments, reassess risk and possible solutions provides a robust case for proceeding with the schemes. We have re-looked at the cost of the schemes as part of our review and will propose completing them at a lower cost than in the revised plan.

- **The EVA: ODI** – the ODI proposed by Ofwat in the DD is complicated and could be viewed as being very punitive. We will propose an alternative that adequately protects customers and is both simple and fair.
- **WACC and financing** – where we believe there is a strong case: not to reduce the WACC further; to calculate the critical credit metrics differently to better reflect Severn Trent's actual credit ratios; and allow for a number of technical issues relating to legacy adjustments in the Ofwat models which all have a material impact on profit after tax. We would also like to make representations on the need for additional PAYG in relation to the financing of the plan.
- **Water maintenance non-infrastructure expenditure** – where there is a strong case, post committing to an action plan with the DWI, and taking into account the unique circumstances for Severn Trent, to accept the proposed cost exclusion for this critical asset class.

We have taken this approach against a backdrop of a number of issues against which we could have made representations/challenge, including areas within the Totex models, the methodology for change protocol and serviceability legacy adjustments and the approach to retail costs.

For example, a list of a number of the more significant areas where we could have challenged the DD is:

- **Water non infrastructure serviceability** – using customer willingness to pay as a basis for the shortfall would lead to a reduction in the shortfall included in the DD. We proposed this approach in our revised plan for both water infrastructure and non infrastructure as it reflected customer valuations of the different service aspects. The case on water infrastructure was accepted, but not on non infrastructure.
- **Wastewater infrastructure serviceability: sewer blockages** – the shortfall applied to this indicator we believe is disproportionate given our performance across the serviceability basket (our performance on the other indicators is within expected levels other than for pollutions – see below).
- **Wastewater infrastructure serviceability: pollutions** – the methodology for reporting incidents has changed significantly over the 2010-15 period and latest information indicates that the revision to the target (made in 2013) has been understated. Given this uncertainty, and the additional evidence now available to support delivery of the pollutions telemetry enhancement programme (data for avoided incidents exceeds that set out in the Final Determination), the shortfall is considered inappropriate. Our performance on pollutions is considered to be amongst the best in the industry, as reported by the Environment Agency.
- **Cost allowance (logging up)** – the costs incurred during 2011-15 in relation to Private Drains and Sewers is below that included in our plan, and the cost exclusion relating to the AMP6 adoption of private pumping stations has been rejected due to materiality. We have undertaken a responsible approach to the adoption of these assets in order to ensure customers receive an appropriate level of service and in

order to ensure a robust cost base for the PR14 Plan. We believe these costs could be further robustly evidenced.

- **Household Retail** – the approach to assessing bad debt does not adequately factor in the underlying bill levels, which leads to a result which seems counter to customer expectations (i.e. there is a disincentive in having a low bill level). Our plan proposed included £25m for increases in bad debt, £10m of which related to increasing bad debt levels due to increases in the nominal bill.
- **Outcome Delivery Incentives** – the change to targets has taken precedence over local customer engagement and priorities, and applied without alignment to totex allowances.

We believe the approach of challenging on such a wide range of issues would potentially undermine the constructive dialogue we have both sought to maintain to date, and as such we would like to proceed on the basis of not challenging on all these areas and instead focusing on the critical issues. This is an approach that we believe demonstrates our commitment to making representations on a small number of critical aspects and frees up time for both sides to delve into them in detail.

We propose that the Ofwat and Severn Trent teams cease to work on the issues we are not proposing to make representations on (e.g. through the query and representation process), and we accept the position as set out in the DD on these issues. If Ofwat were at a later stage to decide to make industry-wide policy changes, which could result in changes to the Severn Trent determination, we would request a suitable time frame in which to respond to any such changes.

This is not something we have proposed lightly, but have listened to the consistent Ofwat feedback that we need to view the business plan “in the round”, and believe this enables the right attention on the most substantive issues.

I look forward to receiving your response to this letter, which I will put a hard copy of into the post.

Best Wishes



**Liv Garfield**  
**Chief Executive**

By email

Liv Garfield  
Chief Executive  
Seven Trent Water Limited

23 September 2014

Dear Liv

**Severn Trent Water's approach to making representations on its draft determination**

Thank you for your letter of 19 September to Sonia Brown.

We appreciate the constructive dialogue that we have had with Severn Trent and other companies throughout the PR14 process and as you know we are keen for this to continue as we move towards final determinations and beyond.

We welcome your overall approach of focused representations, which you have set out in your letter. This will help make the most effective use of resources for both teams and deliver the best outcome for customers. Accordingly, we would welcome any representations you may make in these areas. However, I should point out that there are no guarantees associated with the outcome of our assessment.

On that basis, we will limit our attention to the select issues you identified in your letter. However as explained in [IN14/07 '2014 price review – timetable for representations on draft determinations'](#), we will consider all representations before making our final determination – and this could result in changes to the draft determination position. In addition there is also the possibility for further changes arising from both broader policy issues and our on-going quality assurance process. To the extent that we need to make any changes that are substantive in nature, then we will give you appropriate time to consider the changes and respond. This is clearly, in the spirit of continuing our open and transparent approach

We are publishing this now to be transparent with our stakeholders on the agreement above. I also propose that we treat this letter as part of your representations as it proposes where you would like to direct your representations

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Liv Garfield  
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and how you would like to proceed. We will formally acknowledge all representations from companies and publish them on our website.

Thank you once again for your positive engagement in the price review process and your constructive approach to representations. Please do not hesitate to contact me in Sonia's absence if you wish to discuss the matter further.

Yours sincerely

A handwritten signature in cursive script that reads "Giles Stevens". The signature is contained within a light gray rectangular box.

**Giles Stevens**  
**Portfolio Director**

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