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south east water

# Draft Determination Response Executive Summary

30th August 2019

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## Chairman's Foreword

On 3<sup>rd</sup> September 2018 we published our 2020 to 2025 business plan – the most ambitious and innovative plan we have ever produced. It is a plan that is underpinned by stretching performance commitments and which meets the challenges Ofwat, our economic regulator, has set the industry for this price review.

The plan has been subject to extensive scrutiny and challenge by Ofwat, firstly through its Initial Assessment of Plan (IAP) in January 2019 and more recently in July 2019 when it announced its Draft Determination.

This document summarises our response to the Draft Determination.

### **Balancing challenge and ambition with greater risk and deliverability**

We maintain that our plan is the most ambitious we have ever produced. The performance commitments we have set ourselves are challenging, especially as we operate in a region that is in serious water stress with a growing population.

We have improved a number of our performance commitments as part of this process to address Ofwat's challenge to us. That said, we have largely retained our Business Plan position on the Outcome Delivery Incentives (ODIs) that underpin our performance commitments for three important reasons:

- To reflect customers' priorities and views
- To prevent the detrimental impact of collective risk; and
- To maintain a fair balance between our customers and the company

We now expand on each of these points.

### **Listening to our customers**

Our customers are at the heart of our business plan and it was their priorities and views that rightly influenced all aspects of it. For example they shaped:

- the performance commitments we would rightly be held to account for
- the stretch of the targets that we would need to achieve for each performance commitment
- the design of the incentive rates – including caps and collars – which would attract underperformance penalties and outperformance payments
- the improvements in levels of service that they were willing to pay for

In essence, our package of ODIs reflected the emphasis and importance our customers placed on critical aspects of our performance and service. This meant we accepted that our plan created significant risk of more underperformance penalties for our business than outperformance payments. That being said, in the round, while our performance commitments were highly challenging they would be possible to achieve with our planned level of investment.

However, Ofwat's Draft Determination has removed many aspects of our customers' important input to our ODIs. Crucially, the Draft Determination attempts to create a "virtual upper quartile" company by selecting certain companies to drive each individual performance commitment to a new, untried and untested "package of performance" that, in its entirety, we would argue no company can achieve.

Challenging the industry to improve its performance is commendable, but we maintain that if Ofwat sets performance commitments and ODIs at the Draft Determination levels, without any link back to operating conditions or customer preferences, it creates unsustainable risk – not just financial but reputational too. In *Chapter 2: Delivering outcomes for customers* we have explained in detail why the ODIs proposed by Ofwat in its Draft Determination are neither realistic nor achievable.

We predict more water companies will inevitably fail the performance commitments included in company Draft Determinations than they do now, including in those areas which we know are important to customers, for example water quality compliance, leakage and supply interruptions.

The resulting headlines will be that more of the sector is failing when in fact the actual performance levels will be improving year-on-year, but are still falling short of Ofwat's unrealistic expectations of a "virtual upper quartile" company. This will dent public trust and confidence in a sector that is already facing challenges around these critical areas.

### Collective risk

Ofwat's approach of using simple, individual comparisons on each ODI measure creates a Draft Determination that fails to recognise the impact of collective risk.

A case in point is, in our business plan, we accepted that if our performance continued to be stable at current levels, our carefully-designed package of ODIs and incentive rates for 2020 to 2025 would attract an underperformance penalty of £35 million.

That was a risk we were prepared to take, not least as it articulated the scale of ambition our plan committed us to, and it would rightly incentivise us to improve our performance in proportion to customers' priorities even further.

However, as explained in *Chapter 2: Delivering outcomes for customers*, applying Ofwat's latest individual changes to the design of our ODIs has seen the collective impact become disproportionate when compared with the greater risk we face as a business, as it now attracts an underperformance penalty of £68 million for stable performance.

We believe that the approach demonstrated by Ofwat goes further than just performance commitments and ODIs. Ofwat has taken each component part of our plan and pushed for stretching levels across the board, for example upper quartile costs, upper quartile or stretching performance, lowest cost of capital, which we maintain is a flawed approach, ignoring the undeniable fact that each company has its own unique operational challenges and characteristics.

The approach also ignores the intrinsic dependencies that exist between the component parts of our plan, for example the costs of our plan are directly linked to the ability to achieve our performance commitments.

## A fair balance between customers and company

In-built in our business plan was a considerable downside of underperformance penalties to reflect the scale and ambition of our plan, and the importance our customers placed on key areas of our performance. Our approach was in contrast to a number of other water companies which included an equal balance of outperformance rewards and underperformance penalties, or applied more outperformance rewards.

We believe our approach is the right one and is ably demonstrated with the design of our ODI package and the Return on Regulatory Equity (RoRE): it had the right level of ambition supported by our customers; delivered for the long-term by achieving greater resilience; and represented a fair balance between the interests of customers and the company.

Ofwat has understated the downside risk within the Draft Determination by inappropriately amending key components of the RoRE calculation and omitting the full effects of CMeX and DMeX on the downside. Ofwat's downside for ODIs, for example, is stated as -2.58 per cent compared to our calculation of -3.57 per cent – a level of risk outside of Ofwat's own indication of what would be a reasonable level of exposure that a company could accept.

The amendments made in the Draft Determination have materially increased the downside risk of our ODI package. The potential downside on ODIs is now £106.1 million (including C-MeX and D-MeX) which represents a 78 per cent increase in the potential downside since the IAP.

It is difficult to reconcile this level of potential downside with having been highlighted at the IAP as being a company with a high-quality business plan in relation to our outcomes package, and being one of only three companies to receive a high score for this assessment area.

## Defending our costs

The assessment of costs included in our business plan were based on a detailed review and understanding of:

- our current running costs and the impact of the characteristics of our operational supply area on those costs
- cross-sector benchmarking, particularly for efficiency; and
- our experience of the market and the procurement of services

It was this comprehensive approach, and the use of our industry-leading 'Unit Cost Database', that ensured rigorous challenge of our costs to ensure they were efficient. As a result our business plan delivered considerable service improvements – with additional costs applied only where they were needed to meet stretching performance commitments or were supported by customers – but with no increase in customers' bills.

Ofwat's alternative approach creates cost comparisons 'in the round' and while we agree this is a necessary first step to inform decision-making on price limits for 20 water companies, it cannot be the definitive tool used for making cost decisions. We maintain that the cost modelling approach Ofwat uses to set price limits is inferior to our methods at an individual company level. We have used the 'in the round' assessment to challenge ourselves again, but believe our evidence for maintaining our plan's efficient costs is more compelling and specific to our company, as explained in *Chapter 3: Securing cost efficiency*.

More generally, we remain concerned that in some key areas, such as leakage, Ofwat has:

- taken policy decisions that have a significant cost impact but with little evidence of how that decision takes into account operational realities, good regulatory practice or is supported by the same robust level of customer evidence that water companies have and are required to demonstrate
- ignored our good starting position in terms of lower leakage levels as a result of our customer metering and proactive pressure management initiatives, and which means additional leakage savings will be challenging to achieve without sufficient funding

### **The financing of our plan**

We made clear in our business plan that critical elements – including our totex, performance commitments, ODIs, RoRE and the cost of capital – were designed to work as a complete package. Material changes to any of these elements were likely to have a significant impact on the deliverability of the plan as a whole.

The Weighted Average Cost of Capital (WACC) has also been amended in the Draft Determination. The revised WACC proposed in the Draft Determination is even lower (21 basis points) than the early view presented by Ofwat in its methodology for this price review.

Ofwat's wholesale cost of capital of 5.14 per cent (nominal) materially understates our actual financing costs which we estimated at 5.96 per cent to 6.3 per cent (nominal) in our September 2018 business plan. A key area of difference is that Ofwat is relying on current market data to inform many key parameters (for example, Total Market Return and Risk Free Rate) whereas we draw on long-run market evidence, as per Ofwat's approach at all previous price reviews. Our approach ensures consistency over time whereas Ofwat's approach appears to be selective in its choice of certain parameters.

On that basis we continue to disagree with the approach Ofwat has taken as it fails to recognise our small scale in terms of the amount of embedded debt we hold, and materially understates our actual financing costs for the 2020 to 2025 period.

This position is supported by detailed analysis (*Chapter 5: Aligning risk and return*) conducted by our independent economists which confirms that the proposed rate of return presented in the Draft Determination is inappropriate.

As a result of the revised WACC in the Draft Determination, we also require a further PAYG adjustment of 1.4 per cent to be applied to the 3.4 per cent PAYG adjustment outlined in our IAP response to ensure our business remains financeable on a notional basis.

In addition to this PAYG adjustment, and the other changes we have outlined in our Draft Determination response, we have also significantly reduced the level of dividends for the appointed business in line with our commitment to reduce gearing. This results in an overall dividend yield of 1.77 per cent, compared to 2.35 per cent at the IAP, both of which are significantly below the threshold of five per cent which is considered to be a reasonable yield by Ofwat.

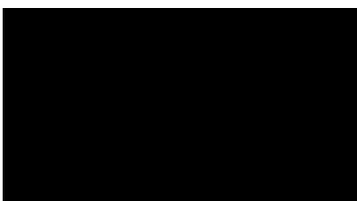
Ofwat has required further board assurance on whether our business plan is financeable, including on the possible further downward pressure on the cost of capital. We do not believe it is either appropriate or possible to provide specific assurance on whether our plan would remain financeable on a notional and actual basis when Ofwat may still make further material interventions in its Final Determination.

### **In summary**

We have welcomed the challenge and scrutiny of our plan by Ofwat. It is an important part of the regulatory process to set prices for a business that provides an essential product and service.

For both the IAP and Draft Determination stages we have meticulously reviewed Ofwat's documentation and critique of our plan so that we are able to provide further evidence and/or justification for the decisions we have made.

This document articulates why, having taken full account of Ofwat's challenges and comments in the Draft Determination, we are retaining the key components of our original plan. It is a plan that was and remains highly ambitious and centred on our customers' priorities.



Nick Salmon  
Chairman

# 1. Our response to Ofwat's Draft Determination

## 1.1 Introduction

On 18<sup>th</sup> July 2019, Ofwat announced the results of its Draft Determination into our 2020 to 2025 business plan.

This document is our response to that Draft Determination. We have asked Ofwat to consider further evidence and justifications before it makes its Final Determination.

The key headlines of our plan are as follows:

	Our 3 <sup>rd</sup> September 2018 plan	18 <sup>th</sup> July 2019 Ofwat Draft Determination	Our 30 <sup>th</sup> August 2019 response
Average household bill	£204	£185	£204
Wholesale costs	£961 million	£825 million	£961 million
Retail costs	£84 million	£87 million	£84 million
Efficiency savings	£45 million	Not applicable	£45 million

## 1.2 Where you can find more evidence

Our more detailed responses and the provision of further evidence to support our position are captured in Chapters 2-8 of this submission as follows:

Chapter	Assessment area
Chapter 1	Executive Summary
Chapter 2	Delivering outcomes for customers
Chapter 3	Securing cost efficiency
Chapter 4	Securing long term resilience
Chapter 5	Aligning risk and return
Chapter 6	Accounting for past delivery
Chapter 7	Securing confidence and assurance
Chapter 8	Data tables and model commentary

## 2. Section 2: Delivering outcomes for customers

### 2.1 Introduction

In its Initial Assessment of Plans (IAP) Ofwat identified us as having one of the highest quality outcomes packages in the industry. Indeed, we:

- were one of only three companies to receive a test score of B for our outcomes package
- the only water-only company to receive this score
- scored more highly on outcomes than two of the three fast-tracked companies

Ofwat's assessment was welcome recognition of the fundamental shift we have made to make our business customer-centric, so that we deliver outcomes that are important to our customers and measure their satisfaction with our service. As a result we developed an outcomes package for our 2020 to 2025 business plan taking a robust and evidence-based approach in order to create our most stretching and innovative performance commitments ever.

However, following on from the IAP, Ofwat has made a number of further changes to our outcomes package in its Draft Determination. These changes are wide-ranging and affect all aspects of the outcomes package, including changes to:

- 4 performance commitment definitions
- 6 of our proposed performance commitment levels
- 9 Outcome Delivery Incentive (ODI) rates
- 1 of our deadbands
- 2 caps and collars; and
- key P10/P90 levels within the Rate of Regulatory Return (RoRE) calculations

These proposals are highly inconsistent with Ofwat's commentary on ODIs and outcomes at the IAP. In its IAP, Ofwat stated the following regarding our plan:

*“Overall, across the delivering outcomes for customers test area, a generally high quality plan, with evidence that is generally sufficient and convincing...South East Water's plan provides evidence of a package of PCs that overall reflects customer views. The company evidences a high quality approach to its PCs and appropriately stretching levels for some PCs. For example, it proposes achieving upper quartile performance for leakage...The company proposes a high quality package of standard outcome delivery incentives (ODI) that follow the PR19 methodology principles and*

*are founded on a well-evidenced approach based on customer views, and a well-justified package of caps, collars and deadbands.”<sup>1</sup>*

In response to Question 1 (‘How appropriate, well-evidenced and stretching are the company’s proposed performance commitments and service levels?’) Ofwat wrote:

*“Companies which perform well on this test question (Anglian Water, South West Water, and South East Water) provide clear and stretching performance commitments, with well evidenced forecasts for their proposed service levels.”<sup>2</sup>*

In response to Question 2 (‘How appropriate and well-evidenced is the company’s package of ODIs?’) Ofwat wrote:

*“Companies which do well on this test question (Anglian Water, South West Water, Yorkshire Water and South East Water) put forward convincing evidence to support their choice of ODI features. They propose outperformance payments where there is strong evidence that doing so would enable them to deliver performance beyond already stretching performance commitments. These companies provide a well evidenced approach to estimating the costs and benefits of different levels of service performance, and use a bottom-up approach to ODI rate calculation based on customer evidence. They do not apply top-down adjustments. Only in very limited circumstances do they apply deadbands.”<sup>3</sup>*

We now respond in more detail to the key challenges we make in our submission.

## 2.2 Our response to the Draft Determination – key challenges

### 2.2.1 Industry wide approach

Ofwat appears to have generally adopted an industry-wide approach to its Draft Determinations on outcomes, and applied multiple, generic changes to **all** slow-tracked companies, regardless of their individual circumstances. A generic approach is particularly ill-suited to ODIs which require evaluation on an individual basis, tailored to reflect the specific characteristics and challenges of each company.

We are concerned with this approach as Ofwat has seemingly disregarded its IAP findings that our 2020 to 2025 business plan was of a high quality when it came to delivering outcomes for customers, which is why it scored highly and led the industry in this assessment area. Ofwat’s overall approach throughout the price review process is therefore inconsistent, and we have not been recognised for the high quality business plan that we put forward in September 2018.

It also fails to recognise that we included, alongside the common performance commitments, a suite of innovative commitments incentivising us to improve customer satisfaction at a customer segment level and to reflect society’s expectation in our responsible business targets.

In fact, the decision by Ofwat to effectively treat all slow-tracked companies the same at the Draft Determination, regardless of how they scored in the IAP, risks reducing the incentives

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<sup>1</sup> Ofwat (2019), Initial Assessment of Plans, South East Water: Test area assessment

<sup>2</sup> Ofwat (2019), Initial Assessment of Plans, Summary of test area assessment, p. 45

<sup>3</sup> Ofwat (2019), Initial Assessment of Plans, Summary of test area assessment, p. 46-47

for companies to submit challenging outcomes in future business plans, as the reward for doing so rests entirely on being able to achieve fast-track or exceptional status.

### 2.2.2 Collective risk

While a case can be made for improvements to individual ODIs, Ofwat's approach of using simple, individual comparisons creates a Draft Determination that fails to recognise the impact of collective risk. For example, we have noted incremental changes between the IAP and the Draft Determination that, when considered collectively, increase the risk to our business significantly.

As we have noted throughout this price review process, our performance commitments and ODI package have been formulated taking a robust and evidence-based approach in order to create innovative and challenging targets. Given that we received such positive feedback at the IAP stage, we did not expect many further changes at the Draft Determination.

However, at Draft Determination a penalty collar was unexpectedly lifted on supply interruptions, so increasing the risk to our business. In addition new material approaches have been made in non-customer facing ODIs, such as mains repairs, imposing an almost-guaranteed penalty with no plausible mechanism by which we can remedy that.

In our business plan we accepted that if our performance continued to be stable at current levels, our carefully-designed package of ODIs and incentive rates for 2020 to 2025 would attract an underperformance penalty of £35 million. That was a risk we were prepared to take, not least as it articulated the scale of ambition our plan committed us to, would rightly incentivise us to improve our performance even further, and was based on having a good understanding of customer's requirements.

Applying Ofwat's latest individual changes has seen the collective impact become disproportionate, as it now attracts an underperformance penalty of £68 million for stable performance. So while each individual comparison may not increase risk unsustainably by itself, taken as a whole it: creates a business plan that no company could realistically achieve; and will compromise the delivery of our outcomes and performance commitments and affect our ability to become more resilient. We provide more detail in *Chapter 2: Delivering outcomes for customers*.

### 2.2.3 The Draft Determination understates the level of risk in the overall ODI package

Table 1 summarises the increase in financial risk we face following Ofwat's amendments to our performance commitments, ODI rates (including deadbands and caps/collars) and P10/P90 levels in the Draft Determination, and how that compares to the IAP.

We are particularly concerned about the amendments made to our P10 levels. We do not agree with the approach adopted and the P10 levels that it results in. In our view, the amendments underestimate the potential risk that the Draft Determination exposes us to as Table 1 shows.

**Table 1 RoRE range – Draft Determination compared to IAP**

TOTAL (ODIs, C-MeX and D-MeX)	Potential downside (P10)	Potential upside (P90)
IAP	-£59.6 million	£10.2 million
Draft Determination – Ofwat calculation	-2.58%	0.37%
Draft Determination – our calculation	-£106.1 million / -3.57%	£15.9 million / 0.55%

As can be seen, the amendments made in the Draft Determination have materially increased the downside risk of our ODI package. The potential downside on ODIs is now £106.1 million which represents a 78 per cent increase in the potential downside since the IAP.

This represents a level of risk outside of Ofwat’s own indication of what would be a reasonable level of exposure that a company could accept i.e. it is above three per cent.

#### *Re-balancing the ODI package*

We have reviewed the changes that Ofwat has made in detail, and also the changes that it has made to other companies’ ODIs, and considered what amendments would result in a more balanced package. Our response outlines the changes that are necessary to our performance commitments and ODIs to return the overall ODI package back to a customer-acceptable – but still stretching – level of risk and reward, as Table 2 shows.

**Table 2 RoRE range – Draft Determination response**

TOTAL (ODIs, C-MeX and D-MeX)	Potential downside (P10)	Potential upside (P90)
IAP	-£59.6 million	£10.2 million
Draft Determination – Ofwat calculation	-£106.1 million / -3.57%	£15.9 million / 0.55%
Draft Determination – response	-£61.6 million / -2.10%	£16.3 million / 0.56%

We are also particularly concerned about our potential downside risk, and how this is spread across our performance commitments in the Draft Determination. Table 3 shows the split of our potential downside across our performance commitments in Ofwat’s Draft Determination, and how our response re-balances this risk.

**Table 3 RoRE range – Draft Determination response comparison by key performance commitments**

PCs	% of total RoRE downside	
	Draft Determination	Our response to Draft Determination
Mains repairs	25%	17%
Supply interruptions	20%	22%
CRI	14%	11%
Leakage	12%	17%
PCC	5%	9%
Others	24%	24%

#### *Additional impact of amending P10 levels*

We note that the P90/P10 levels we have included – and which have underpinned our RoRE calculations for our ODIs – are based on us being allowed the level of totex that we have submitted.

It is vital that we retain the totex detailed in our business plan (*Chapter 3: Securing cost efficiency*) but if Ofwat chooses not to allow it, then our performance – and P10 underperformance penalties – will inevitably get worse. That will have a further knock-on effect on our RoRE calculations and increase the risk to our business even further.

#### **2.2.4 Our response to the Draft Determination – specific observations**

In this section we outline some of the key adjustments we require to our ODI package. This is a critical element of the price control which cannot be viewed in isolation and, should these adjustments not be accepted, it is likely to have a significant impact on the deliverability of the package as a whole.

#### *Compliance Risk Index*

The Draft Determination amends our ODI rate and also the level of the deadband.

Ofwat has in effect altered the incentive rate seemingly on the basis that we have had historic water quality issues. However, in our company specific actions appendix, Ofwat states that *“the company has no performance issues”*.<sup>4</sup>

There is therefore a lack of clarity as to the reasoning behind Ofwat’s action. Its approach, as set out in its policy appendix, shows that companies should be given the average of the range, only if they have performance issues. We do not have performance issues, as Ofwat has identified and so we do not agree with this action.

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<sup>4</sup>Ofwat (2019), PR19 Draft Determinations, South East Water – Delivering outcomes for customers actions and interventions, SEW.OC.A9, p. 6

We have provided additional evidence of our good water quality performance to justify the level of the incentive rate commensurate with this performance.

### *Supply interruptions*

The Draft Determination amends our PC levels, our ODI rates and also the level of our cap and collar.

While we accept the industry-wide amendment to the PC levels, we do not agree with the amendment to our ODI rates.

One of the core aspects of the outcomes framework is that the ODI rates are calculated on the basis of the value that customers place on driving a change in levels of service. These valuations are important pieces of evidence and our research clearly showed that our customers value improvements in other performance areas more highly, and when compared with customers elsewhere in the country.

It is therefore disappointing that Ofwat has ignored our customers' views and instead relied on an arbitrary combination of our proposed rate for 2025, our current rate in this period, and also the industry average to determine our ODI rate for interruptions to 'triangulate' an ODI rate. The industry average is around five times the scale of both our proposed and current rates, while ours in both the current and next period are relatively similar (both around £0.1m per minute).

In addition to this, Ofwat's overall approach to reviewing and assessing ODI rates is inconsistent. Ofwat does not trust each individual company's own valuation data and instead calculates the average and standard deviation of all the companies' data to identify industry outliers.

Given that the sample size is so small, we would argue it is incorrect for Ofwat to assume that the average of this dataset is any more robust than the individual data points – and so it is inappropriate of Ofwat to use the average to determine industry outliers and apply the industry average to those companies.

We therefore propose that we use our current rates for the 2020 to 2025 period, as this ensures the ODI rates are based on our own customers' valuations rather than a manufactured dataset that reflects no particular group of customers.

### *Mains repairs*

The Draft Determination amends our PC levels (taking the average of the best three years) and also our ODI rates. We did not propose a collar for this PC and Ofwat has not applied one in its Draft Determination.

We strongly object to the amendment to our PC levels for the following reasons:

- This PC alone accounts for 25 per cent of our overall P10 downside. As this is a non-customer facing PC, it is entirely inappropriate for us to have such a material downside on this one PC
- This is an asset stability measure. Our licence requires us to remain stable on this PC, rather than deliver material improvements. We have been stable on this PC since 2005
- We have delivered significant leakage reductions in 2015 to 2020 reaching an upper quartile level of performance. We have largely achieved this mainly by preventing bursts through pressure management, surge reduction and mains alterations, offset by also proactively seeking out burst mains. We have continued to commit to

delivering a stretching leakage reduction in 2020 to 2025, but the reality is as we have exhausted pressure management initiatives – therefore the activities and interventions available to drive leakage down further are now more limited. We will focus more on proactive burst mains detection and repairs, including via smart metering, rather than burst prevention. It is therefore not possible for us to commit to our leakage PC levels **and** also achieve an improved level of mains repairs. That is why in our business plan we stretched ourselves to hold burst mains repair numbers stable while delivering further leakage reductions

In addition to these specific observations, we have also responded to Ofwat's detailed actions in a number of other areas which are set out in *Chapter 2: Delivering outcomes for customers*.

## 3. Section 3: Securing cost efficiency

### 3.1 Introduction

In generating this response we have examined Ofwat's comments within our Draft Determination and have explored all the supporting models and supporting materials.

We also examined other water companies' Draft Determinations and looked at all the evidence supporting Ofwat's comments.

After careful consideration we took the decision to not alter our September 2018 business plan costs for our Draft Determination response for the following reasons:

- For our business plan we undertook a full assessment of efficiency using a multitude of benchmarking and internal challenges, and duly considered Ofwat's assessment as one more piece of evidence in that overall assessment
- Ofwat's models are broad brush and aimed at setting price control efficiency "in the round" and as such are not as robust as the company-specific assessment we have deployed
- Ofwat's models show unexplained inconsistencies across our cost base that put into question their reliability and accuracy at an individual company level – for example we are efficient on base costs but supposedly inefficient on growth costs, but in essence they are the same activity. Inconsistencies such as this suggest different levels of activity between water companies is being articulated as inefficiency within Ofwat's approach
- Ofwat has not taken account of current performance or performance improvements in setting totex allowances or efficiency levels

We consider it is inappropriate to apply generic additional efficiency targets beyond those which we already included in our business plan, and which were rigorously challenged as we reviewed all our costs. We provide additional information and evidence within our submission at *Chapter 3: Securing cost efficiency*, setting out our business plan assumptions and the allowances made.

On the key investment items, we also provide supporting evidence where requested – for example we demonstrate that our resilience schemes are now supported using the newly-developed, more formal, integrated resilience framework.

For base costs we have looked closely at the models and are concerned that growth is not properly considered and differing levels of activity are being expressed as inefficiency due to inappropriate cost drivers and the inability of an econometric model approach to properly explain these type of costs. We have therefore proposed changes to the models to improve them and increase their robustness, and where we believe models are inappropriate we have identified this and proposed alternative methods to arrive at efficient costs.

More generally, we have significant concerns with certain policy positions driving significant cost impacts – notably on leakage where there is little evidence of how Ofwat's decision takes into account operational realities, good regulatory practice or is supported by the same robust level of customer evidence that water companies have and are required to demonstrate.

### 3.2 Our response to the Draft Determination – key challenges

We have serious concerns with the cost proposals put forward in the Draft Determination and the key challenges are outlined in this section.

#### 3.2.1 Wholesale costs summary

Table 4 summarises the position on base and enhancement costs following Ofwat's Draft Determination.

**Table 4 Business Plan to Draft Determination cost summary**

Expenditure - totex models	SEW Business Plan	Ofwat Draft Determination
	£m	£m
Base modelled costs	623	579
Un-modelled costs	121	110
Enhancement	262	178
Other items	22	19
<b>Wholesale totex models</b>	<b>1,028</b>	<b>886</b>

#### *Base costs*

We maintain that the models used by Ofwat to determine base costs are creating unexplained inconsistencies – for example we are efficient on base costs but supposedly inefficient on growth costs, but in essence they are the same activity.

Our view is that the model is not taking account of the right factors on growth, such as the capacity of the existing network. It assumes all new connections require the same activity and presumes any difference between companies is inefficiency. We demonstrated within our IAP response that this is clearly a flawed assumption. This is a critical issue for a company such as ours, which operates in region which continues to see population and housing growth. We propose an alternative approach to setting growth cost efficiency in our detailed response (*Chapter 3: Securing cost efficiency*). We also make more detailed recommendations on changes to the model, for example amending density factors to improve its robustness.

In addition, certain unmodelled costs continue to be significantly underfunded at the Draft Determination, with a variance of £11.8 million. This is largely as a consequence of Ofwat's failure to recognise the impact of mid-term revaluations which mean we will face higher local authority business rates. We maintain that our forecast business rate costs should be included in the Final Determination.

### *Enhanced costs*

We have particular concerns around the gap in allowed expenditure in the following key areas – zonal growth, resilience, leakage and vulnerability – and so have provided additional evidence. Our detailed response on this issue is set out in *Chapter 3: Securing cost efficiency* but is summarised in the following sections.

### Zonal growth

Zonal growth, in simple terms, represents activity and expenditure that is needed to meet increasing demand in areas where there is not enough water available. We remedy this problem by moving water from areas where there is surplus water to areas where there is a shortfall.

Our business plan outlined four schemes that were necessary to help move water within our supply area, so as to improve the capacity and connectivity of our network and maintain supplies to customers.

In its Draft Determination Ofwat agreed with the need for two of these schemes but has challenged us to provide more detail on costs and the process by which these schemes were selected, which we do in our detailed submission (*Chapter 3: Securing cost efficiency*).

### Resilience

Our 'resilience in the round' approach for our business plan used a much broader lens to determine the interventions and investment we would need to make, so that our business becomes more resilient.

That lens looked beyond traditional engineering solutions to consider resilience in our operations, in the natural environment and among our customer base, an innovative approach which created our resilient customer concept.

That said, Ofwat's Draft Determination stated that we did not demonstrate the need for investment in line with its resilience definition and criteria for acceptance.

It also required us to:

- prepare a more formal resilience framework and action plan (using the four Rs of redundancy, resistance, reliability and recovery as the guiding principles)
- provide further evidence on the cost efficiency of our selected resilience schemes which, while they have a low probability of happening, would have a high impact on customers

Our resilience framework was submitted to Ofwat on 22<sup>nd</sup> August 2019 and we have re-run our resilience schemes through this framework. In our detailed submission (*Chapter 3: Securing cost efficiency*) we demonstrate they remain the optimum schemes to protect customers' water supplies.

## Leakage

Our IAP response contained significant evidence that additional leakage expenditure should be supported, giving clear examples of regulatory precedent, efficient delivery and other rationale for supporting this position.

We remain disappointed at Ofwat's failure to take account of our evidence and submissions on leakage expenditure. It has provided limited detail or explanation to justify its approach, or clarified why the evidence we have provided to date is not considered satisfactory enough to secure the additional funding. Indeed, the industry remains unsighted of how evidence submitted to Ofwat has fallen short of its expectations, or what is required to make a successful submission.

The current approach across the whole Draft Determination on leakage has the following attributes:

- It does not follow any other regulatory precedent where a clear change to levels of service is required but without the additional expenditure necessary
- It implies that flat leakage levels across the industry in recent years represents a failure that needs correcting, but fails to recognise the key driver for this being regulatory policy and existing incentives
- Assuming leakage costs are in base costs and no additional costs are required to deliver a further 15 per cent reduction places, in effect, a material efficiency challenge on the industry
- It fails to recognise performance within the cost models i.e. there are no components of the totex models that consider a company's current leakage performance. The costs we have incurred in achieving upper quartile leakage performance in the 2015 to 2020 period will be categorised as inefficient. That is clearly inappropriate
- Failure to fund further leakage reductions in effect underfunds our statutory Water Resource Management Plan process and undermines the obligation we have to maintain the supply demand balance
- It removes any incentive to reduce leakage further after 2025 unless the policy position is changed
- It fails to recognise that customers do not consider the current leakage position should be remedied for free – they are willing to pay for further leakage reductions
- It fails to recognise the relationship between locating burst mains and lower leakage to such an extent that it incentivises companies to not find leaks as the penalty on bursts are disproportionately more aggressive when compared to the rewards on leakage

We maintain that water companies are not in a position at present to deliver the size and scale of leakage reduction being proposed during 2020 to 2025 at no additional new cost – and especially given the overwhelming evidence that, when it comes to our customers, they are willing to fund the levels of investment necessary to deliver the further leakage reductions our plan has committed to that will take our performance way beyond the current industry frontier.

## Vulnerable customers

We are disappointed Ofwat considers the comprehensive suite of additional services and activities for vulnerable customers should be considered part of our base service and costs. It is clear that no drivers for affordability exist within the wholesale base models so this statement is unsupported and inaccurate.

We are already an upper quartile performing company in this area but committed to a significant step change for the 2020 to 2025 period to keep our services affordable, accessible and protective for more customers than we do now. For example, our target for customers on the Priority Services Register is 10 per cent of our customer base, considerably above Ofwat's suggested minimum target of seven per cent.

As with leakage, we have clear evidence to show that customers are willing to fund additional investment so that we can expand our service provision in this critical area, so would strongly urge Ofwat to reconsider its decision.

### 3.2.2 Cost efficiency

The triangulation of our efficiency approach, and the continuation of key activities we have commenced since 2015, have been used to create our overall efficiency challenge. The output from this analyses provided a clear indication of:

- our relative efficiency compared to the leading water companies in the market
- the extent of efficiency required in the 2020 to 2025 period to maintain our position as an industry-leading efficient business; and
- the specific areas that require improvement during the period

Our current efficiency position in general has been good when compared to other companies in the sector, but we recognise the opportunities that exist in the next period to improve and provide better value to our customers.

Ofwat concludes that a 1.5 per cent per annum general efficiency to base costs should be achievable by water companies. However, we maintain that frontier efficiency is more appropriately set at one per cent per annum as consistent with our business plan and IAP submission, and provide further robust evidence in *Chapter 3: Securing cost efficiency* to support our position.

## 4. Section 4: Securing long term resilience

### 4.1 Introduction

In this section we outline our challenges to Ofwat's Draft Determination on the financial aspects of our plan.

### 4.2 Our response to the Draft Determination – key challenges

#### 4.2.1 Credit rating and long term resilience

Ofwat continues to challenge the basis on which a Baa2/BBB credit rating is consistent with achieving long-term financial resilience. As outlined in *Chapter 5: Aligning risk and return* we explain why our proposed credit rating of Baa2/BBB has proven consistent with being financially resilient, not least as shown by the recent successful completion of our large re-financing exercise.

In terms of actual financeability, our analysis shows that at total company level we retain our Baa2 credit rating, although headroom is reduced as a result of the decrease in WACC. There is however the need for an additional adjustment on PAYG of 1.4 per cent to achieve notional financeability.

We address this in more detail at sections 5.2.3 and 5.2.6 of this document and *Chapter 5: Aligning risk and return*.

#### 4.2.2 Board assurance on financeability post Draft Determination

The revised WACC proposed in the Draft Determination is even lower (21 basis points) than the early view presented by Ofwat in its methodology for this price review. Furthermore Ofwat has signalled its expectation that WACC will reduce further when it makes its Final Determination.

We have provided assurance in our Draft Determination response applying Ofwat's revised WACC (i.e. 21 basis points reduction) on the understanding that the critical elements of our response are materially accepted as a package. As a result of this revised WACC, we require a further PAYG adjustment of 1.4 per cent to be applied to the 3.4 per cent PAYG adjustment outlined in our IAP response to ensure our business remains financeable on a notional basis.

However, Ofwat has required further Board assurance on whether our business plan is financeable, including following possible further downward pressure on the cost of capital of 37 basis points. We do not believe it is either appropriate or possible to provide specific assurance on whether our plan would remain financeable on a notional and actual basis when Ofwat may still make further material interventions within its Final Determination.

Our analysis shows that a further reduction in the WACC of 37 basis points would cause at least a one notch downgrade to our rating for the notional company to Baa2 and seriously compromise our ability to maintain a robust investment grade credit rating.

## 5. Section 5: Aligning risk and return

### 5.1 Introduction

We made clear in our business plan that critical elements – including our totex, performance commitments, ODIs, RoRE and the rate of return – were designed to work as a complete package. Material changes to any of these elements were likely to have a significant impact on the deliverability of the plan as a whole.

In this section we outline our challenges to Ofwat's Draft Determination on the financial aspects of our plan.

### 5.2 Our response to the Draft Determination – key challenges

#### 5.2.1 WACC (Draft Determination)

As the Draft Determination overview outlines, Ofwat is proposing the lowest cost of capital ever since the privatisation of the water sector. We continue to have fundamental concerns about how Ofwat has assessed this and the impact that this position will have upon much needed investment in the water sector.

As outlined in our detailed submissions at *Chapter 5: Aligning risk and return* we consider that Ofwat's position is at odds with the economic evidence. For example, Ofwat's Draft Determination wholesale cost of capital materially understates our actual financing costs. A key area of difference is that Ofwat relies on current market data to inform many key parameters whereas we draw on long-run market evidence as per Ofwat's approach at all previous price controls. Our approach ensures consistency over time, whereas Ofwat's approach appears to be selective in its choice of certain parameters.

Ofwat's own analysis of our financeability is flawed because it incorrectly excludes pension costs in the calculation of ratios and fails to assess ratios in line with rating agencies' approaches, notably Moody's Adjusted Interest Coverage Ratio (AICR).

After adjusting for these items, and taking into account its early view of the cost of capital, Ofwat's updated cost of capital leads to outturn financial ratios consistent with a Baa2/BBB rating for the notionally financed capital structure and is therefore inconsistent with the A/BBB rating that underpins Ofwat's cost of debt. Ofwat's Draft Determination therefore fails the financeability test i.e. a test for consistency of its overall proposals.

In the light of the failed financeability test, Ofwat should revisit its cost of capital such that it leads to outturn notional ratios and a credit rating consistent with the rating inherent in the WACC allowance. However, for this price review, Ofwat has instead directed companies to propose adjustments to the PAYG rate or RCV run-off to ensure that companies are financeable on a notional basis. As we are committed to produce a financeable Draft Determination response we have used Ofwat's directed adjustments.

#### 5.2.2 WACC (Final Determination)

Ofwat has also signalled its expectation that WACC will reduce further when it makes its Final Determination. Our analysis shows this would cause at least a one notch downgrade to the rating for the notional company to Baa2, which could be at further risk given the impact on AICR.

A further reduction in WACC would seriously compromise our ability to maintain a robust investment grade credit rating (see section 4.2.1) and could not be remedied by additional uplifts to PAYG, beyond what we have already demonstrated is necessary as a result of Ofwat's Draft Determination of our plan (see section 5.2.3).

The extent of this further reduction is yet to be determined. We consider that, should Ofwat decide to proceed with a further intervention in downgrading the WACC, it must fully consult on the change, and the reasons and evidence it is relying on to support any change so as to give companies an opportunity to comment on the cost of capital that Ofwat proposes to implement at the Final Determination. This is all the more important given the knock-on effect that such a significant change would have across the price control.

### 5.2.3 PAYG adjustment

We have revisited the PAYG adjustment required in light of Ofwat's assumptions around the WACC in its Draft Determination.

An incremental 1.4 per cent will be required to the 3.4 per cent PAYG adjustment outlined in our IAP response to ensure notional financeability. The adjustment has been derived using the same approach as outlined in our IAP response. Given our very low RCV run-off rate, we still recover a low proportion of costs from today's customers relative to the industry average despite our required PAYG adjustment.

### 5.2.4 Pensions

Ofwat has disallowed pension contribution costs but allowed pension deficit repair costs in its Draft Determination financial models.

We maintain that the inclusion of the pension contribution costs is necessary and consistent with the final regulatory financial model used at the last price review. To exclude these costs implies outperformance of the regulatory settlement, which is not just erroneous but also overstates mean-expected financial headroom for key credit metrics such as AICR.

### 5.2.5 Gearing

Despite our continued opposition to the premise of the gearing penalty proposed by Ofwat (and as set out in our response to Ofwat's consultation, 17 May 2018), we remain committed to making a £54 million equity injection into the business at the start of the 2020 to 2025 period to reduce our level of debt over the five-year period.

That being said, the projected level of gearing has increased since the IAP due to:

- the lower WACC included in the Draft Determination; and
- a lower opening balance of our regulatory capital value (RCV) due to the recent adjustments made as part of the PR14 reconciliation process

### 5.2.6 Credit rating

Ofwat continues to challenge the basis on which a Baa2/BBB credit rating for our actual company is consistent with achieving long-term financial resilience.

We have reassessed the financial position of our actual financeability and maintain that a Baa2/BBB rating would support our long-term resilience as set out in our IAP response. Our detailed response also shows that at total company level we retain our Baa2 credit rating, although headroom is reduced as a result of the decrease in WACC.

### 5.2.7 Dividends

Table 5 and Table 6 show the dividend profile and yield included in our Draft Determination response when compared to the level in the IAP.

Taken alongside the other changes we have outlined in our Draft Determination response we have also significantly reduced the level of dividends for the appointed business, in line with our commitment to reduce gearing.

This reduction in dividends is in addition to the £54 million equity injection we have already committed to. This results in an overall dividend yield of 1.77 per cent compared to 2.35 per cent at the IAP, both of which are significantly below the threshold of five per cent which is considered to be a reasonable yield by Ofwat.

**Table 5 Appointee dividends IAP submission versus Draft Determination response**

£m	2020/21	2021/22	2022/23	2023/24	2024/25	AMP7 Total
IAP	-	6.84	8.83	13.18	15.68	44.53
Draft Determination response	-	10.00	9.70	4.00	7.00	30.70
Reduction						-13.83

Source: SEW actual PR19 Ofwat model

**Table 6 Appointee dividend yield IAP submission versus Draft Determination response**

%	2020/21	2021/22	2022/23	2023/24	2024/25	AMP7 Total
IAP	-	1.96%	2.41%	3.45%	3.95%	2.35%
Draft Determination response	-	3.05%	2.81%	1.11%	1.87%	1.77%
Reduction						-0.58%

Source: SEW actual PR19 Ofwat model

## 6. Section 6: Accounting for past delivery

### 6.1 Introduction

Our business plan (*Chapter 10: How this plan builds on our current performance*) and our IAP response (*Chapter 8: Accounting for past delivery*) detailed at length how we have performed in the current period.

We do not intend to repeat those commentaries in this response, but provide the specific further evidence requested by Ofwat in its Draft Determination (*Chapter 6: Accounting for past delivery* and *Chapter 2: Delivering outcomes for customers*)

We do however make representations on the adjustment Ofwat has made to the Service Incentive Mechanism (SIM).

### 6.2 Our response to the Draft Determination – key challenge

#### 6.2.1 SIM adjustment

We were not expecting this adjustment and do not agree with the methodology used by Ofwat to calculate this adjustment.

In its Draft Determination, Ofwat shows all companies' SIM scores for the period 2015/16 to 2018/19 and calculated the SIM payments associated with each of these performance levels.

Ofwat states that it has calculated SIM payments as follows:

*“Calculate the relative distance for each company between the top and bottom performer and calculate the percentage performance payment using this, allocating a +6% outperformance payment for the best performing company's score, and a -12% underperformance payment for the worst performing company's score.”*

Ofwat has not allowed for a 'no payment zone', despite there having been one when SIM payments were calculated for 2010 to 2015 and including one in the new C-MeX methodology. Ofwat's approach for 2015/16 to 2018/19 is therefore unusual and out-of-line with the way that all other customer service payments have been calculated or are proposed to be calculated in the future.

Since Ofwat allowed for a 'no payment zone' when calculating this current period's payments, it was reasonable for us to assume that it would adopt the same approach to calculating SIM payments for 2015/16 to 2018/19. It is poor regulatory practice to materially change the way incentives are calculated after the fact, as this increases uncertainty and risk for companies – such uncertainty is likely to undermine investor confidence in the transparency and stability of the regulatory framework and result in adverse impacts on future investment.

We have applied the logic of this approach to the SIM scores for 2015/16 to 2018/19 to infer what our SIM payment would have been, if there was a no payment zone in place. On that basis our updated tables and feeder models do not include any adjustment for SIM.

## 7. Section 7: Securing confidence and assurance

### 7.1 Introduction

Our board continues to take collective responsibility for assuring all stages of the business plan process, including for our Draft Determination response. We have produced a separate board assurance statement for our documentation.

As referenced at section 4.2.2 of this document, Ofwat has required further board assurance on whether our business plan is financeable, including following possible further downward pressure on the cost of capital. We do not believe it is either appropriate or possible to provide specific assurance on whether our plan would remain financeable on a notional and actual basis when Ofwat may still make further material interventions within its Final Determination. Our analysis shows that a further reduction in the WACC of 37 basis points would cause at least a one notch downgrade to our rating for the notional company to Baa2 and seriously compromise our ability to maintain a robust investment grade credit rating.

We now summarise the assurance framework, controls and oversight we have in place for our response, and not least to ensure our response accords with the principles we have adopted for the Company Monitoring Framework (CMF).

### 7.2 Governance and assurance

We have previously detailed at length the assurance process we have taken for both our September 2018 business plan (*Appendix 20: PR19 Governance and Assurance*) and for the IAP (*Chapter 9: Securing Confidence and Assurance*).

We do not intend to replicate large elements of these documents but now summarise the assurance steps we used for this Draft Determination response. More detail can be found in *Chapter 7: Securing Confidence and Assurance* of this submission.

#### 7.2.1 Assurance principles

Our three-tiered assurance process that we set out in our business plan (see *Appendix 20: PR19 Governance and Assurance*) continues to provide the basis of how we have assured both our IAP and Draft Determination response submissions. We have also applied the additional measures identified from Ofwat's 2018 assessment of our CMF to both submissions.

As noted in the IAP response, we have additional assurance steps to address the minor concerns raised in Ofwat's assessment of this test area. These additional steps will ensure the accuracy and quality of our resubmission material and data.

#### 7.2.2 Our assurance process

We have undertaken a seven-stage process for the assurance of our Draft Determination response as Table 7 shows:

**Table 7 Our assurance process**

Process stage	Summary of key activities
Assurance management	<p>The assurance framework used for our Draft Determination response is managed to ensure it complies with our CMF. Any required changes to data tables and models are controlled via change control logs that provide an audit trail to the source data.</p>
Preparation and data collection	<p>Population of data tables with IAP submitted data to ensure consistent starting point and any changes can be tracked, with additional assurance checks in place.</p> <p>All Draft Determination interventions and actions assigned to senior table owner with sign-off process and independent assurance identified.</p>
Internal Assurance	<p>Manual cell-by-cell internal assurance of data tables by independent reviewer and additional level of automatic review.</p> <p>Response documentation produced in line with data tables and financial model to ensure consistency, with Head of/Executive Director ownership of all supporting material.</p>
External Assurance	<p>Independent, external assurance carried out where there has been a change to the input data or a new Ofwat requirement.</p>
Consistency review	<p>Internal consistency checks on data between IAP and Draft Determination and cross referenced to 2019 Annual Report. Additional assurance checks to ensure data tables are consistent with Financial Model.</p>
Formatting of data tables	<p>Independent checks have been carried out on the submission version of the data tables to ensure all the formatting and presentation requirements have been met.</p>
Board assurance	<p>South East Water's board of Directors recognise their collective responsibility and duty to provide the strategic leadership for a business that provides an essential service; and to promote good corporate governance and professional conduct within a framework of effective controls that identify and manage any risks to the provision of that service.</p> <p>The board has continued to own the overall strategy and direction of our business plan and our response to Ofwat's Draft Determination of our plan, providing rigorous scrutiny to all its key components.</p> <p>They have also ensured appropriate controls are in place to assure the quality of our Draft Determination response which has been reinforced by thorough internal and external validation.</p> <p>A separate Board Assurance Statement has been included as part of our Draft Determination response.</p>

### 7.3 Our response to the Draft Determination – key challenges

#### 7.3.1 Dividends

Ofwat requires further evidence on how our dividend policy is linked to the company's performance.

We maintain our objections to Ofwat's dividend policy as outlined in our response to the consultation dated 17 May 2018 on the basis that companies should be free to choose their actual financial structure without regulatory intervention (subject to compliance with licence obligations).

That said, we have updated our dividend policy and this is set out in our response documentation (*Chapter 5: Aligning risk and return*) and demonstrates how the appointed business dividend will be set – reflecting gearing requirements, key financeability constraints and linked to company performance.

A key principle is that the dividend related to the appointed business and the non-appointed business will be assessed separately.

#### 7.3.2 Executive Pay

Ofwat has requested further clarification on the company's Executive Pay policy, including the design of any annual and long-term bonus schemes, and how they are linked to the company's performance.

We confirm that Executive Pay targets will be set by reference to the Final Determination and will define the stages at which levels of performance, for each performance commitment, may attract bonus payments.

This is consistent with our approach for defining our performance commitments, the RoRE methodology and our own assessment of the appropriate level of improvement that is required from the current period. It also preserves the flexibility the Remuneration Committee will need to finalise the Executive Pay incentives for 2020 to 2025.

## 8. Section 8: Board assurance statement

As Directors of South East Water we recognise our collective responsibility and duty to provide the strategic leadership for a business that provides an essential service; and to promote good corporate governance and professional conduct within a framework of effective controls that identify and manage any risks to the provision of that service.

We have continued to drive the overall strategy and direction of our business plan, our IAP response and our response to Ofwat's Draft Determination, providing rigorous scrutiny to all its key components.

We have also ensured appropriate controls are in place to assure the quality of our Draft Determination response which has been reinforced by thorough internal and external validation.

In particular, we confirm that the assurance framework we have in place covers the specific actions set out in Ofwat's test areas of "Securing confidence and assurance", "Aligning risk and return" and "Long term resilience" namely:

- Action CA.A1 – Dividend policy
- Action CA.A2 – Executive pay
- Action LR.A5 – Gearing and credit rating
- Action RR.A2 – Gearing and credit rating

The revised WACC proposed in the Draft Determination is even lower (21 basis points) than the early view presented by Ofwat in its methodology for this price review. Furthermore Ofwat has signalled its expectation that WACC may reduce further when it makes its Final Determination.

As outlined in our detailed submissions at *Chapter 5: Aligning risk and return* we continue to have fundamental concerns about how Ofwat has assessed this level of WACC and its flawed analysis of our financeability which incorrectly excludes pension costs in the calculation of ratios and fails to assess ratios in line with rating agencies' approaches, notably Moody's Adjusted Interest Coverage Ratio.

In the light of the failed financeability test, Ofwat should revisit its cost of capital such that it leads to outturn notional ratios and a credit rating consistent with the rating inherent in the WACC allowance. However, for this price review, Ofwat has instead directed companies to propose adjustments to the PAYG rate or RCV run-off to ensure that companies are financeable on a notional basis. As we are committed to produce a financeable Draft Determination response we have used Ofwat's directed adjustments.

We have provided assurance in our Draft Determination response applying Ofwat's revised WACC (i.e. 21 basis points reduction) on the understanding that an additional PAYG adjustment of 1.4 per cent is made and the critical elements of our response are materially accepted as a package.

However for one specific action – LR.C1 Further reduction in WACC – Ofwat has required further board assurance on whether our business plan is financeable, including following possible further downward pressure on the cost of capital of 37 basis points. We do not

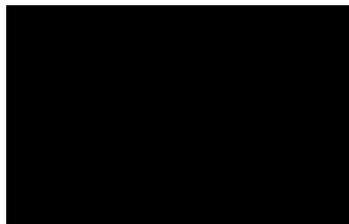
believe it is either appropriate or possible to provide specific assurance on whether our plan would remain financeable on a notional and actual basis when Ofwat may still make further material interventions within its Final Determination.

That being said, we remain confident that our business plan and Draft Determination response will, over the next control period and in the long term, enable the company to:

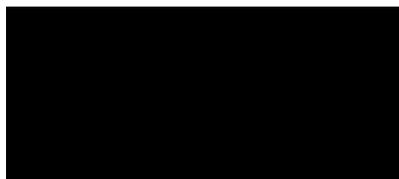
- fulfil its statutory and licence obligations
- remain resilient – operationally, financially and corporately
- meet the expectation of the UK government's strategic policy statements

**Board signatures**

Nick Salmon (Independent Chair)



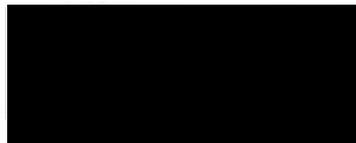
John Barnes (Independent Non-Executive Director)



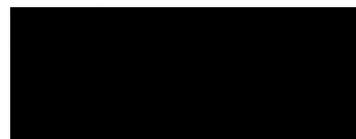
Celia Pronto (Independent Non-Executive Director)



Chris Girling (Independent Non-Executive Director)



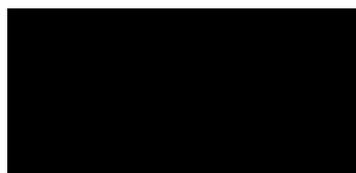
Stephen Jordan (Shareholder-Nominated Non-Executive Director)



Marissa Szczepaniak (Shareholder-Nominated Non-Executive Director)



Paul Butler (Managing Director)



Andrew Farmer (Finance Director)



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