

## APPENDIX – DETAILED REPRESENTATION

### Dividend yield and base dividend

1. South West Water's dividend policy, as set out in our business plan and with further detail provided in this response, sets our base dividend from the price determination with reference to the notional balance sheet.
2. For the purposes of assessing financeability (rather than reflecting a base dividend policy) in our plan we included an estimate of base dividends calculated on a 4% yield + 1% growth assumption (i.e. 5%).
3. For the purposes of setting a base dividend aligned with our policy, we would expect this to reflect base equity returns included within revenue, with a consistent approach across the sector.
4. The proposed revised dividend values are included in the following table and despite this increase SWW would continue to have the strongest position with gearing increasing to c.58.5% (from 57.9%) and dividend cover reducing to c.1.8 (from 2.2) but remaining favourable to the other fast-track companies. This change will not impact the revenue allowed within the determination.

|                          | 2020/21<br>£m | 2021/22<br>£m | 2022/23<br>£m | 2023/24<br>£m | 2024/25<br>£m | K7<br>£m |
|--------------------------|---------------|---------------|---------------|---------------|---------------|----------|
| <b>DD Representation</b> | 63.6          | 65.0          | 66.5          | 67.9          | 68.9          | 331.9    |

5. This base dividend will continue to be aligned with our dividend policy and will ensure that our base dividend is anchored in the base allowances approved by the regulator to give customers assurance that they are fair and balanced and that as a responsible company our notional gearing remains consistent with Ofwat's view. This approach of aligning our base dividends with regulatory allowances was endorsed by the independent WaterShare panel.
6. From the published fast-track determinations South West Water's notional financial ratios are the strongest and this change would re-align our ratios with our plan.

| Financial Ratios                           | Severn Trent |        | South West Water |        | United Utilities |       |
|--|--------------|--------|------------------|--------|------------------|-------|
|  | Plan         | DD     | Plan             | DD     | Plan             | DD    |
| Gearing                                    | 61.3%        | 60.0%  | 61.0%            | 57.9%  | 59.9%            | 58.9% |
| Interest cover                             | 3.89         | 4.08   | 4.36             | 4.73   | 4.01             | 4.05  |
| Adjusted cash interest cover ratio (ACICR) | 1.56         | 1.48   | 1.82             | 2.00   | 1.55             | 1.54  |
| Funds from operations (FFO)/Net debt       | 10.48%       | 10.02% | 10.92%           | 11.93% | 9.73%            | 9.81% |
| Dividend cover                             | 1.40         | 1.42   | 1.52             | 2.16   | 0.96             | 1.00  |
| Retained cash flow (RCF)/Net debt          | 7.84%        | 7.62%  | 7.60%            | 9.54%  | 6.30%            | 6.66% |
| Return on capital employed (RoCE)          | 5.49%        | 4.65%  | 5.29%            | 5.37%  | 4.62%            | 4.34% |

7. Based on this assessment we are seeking to reflect dividends consist with the returns within revenue to ensure that the gearing levels at a notional level are more aligned with the PR19 methodology.
8. In addition, we believe that this would provide greater consistency in the approach to publishing dividends and dividend yields as we progress to the final determination.

### **Isles of Scilly costs**

#### We would like to continue the constructive engagement with Ofwat on the treatment of the Isles of Scilly costs.

9. We would like to reiterate the point that this is a great undertaking which no other water company would support. Our Board believed by expressing an interest it was the right thing to do for the communities on the islands and in the wider interest of public health and the environment.
10. We understand Ofwat's responsibilities in ensuring that protections are put in place for customers however the Isles of Scilly are a new undertaking and a new obligation. We believe the costs were well evidenced at submission, and since fast track new and emerging issues are materialising which have the potential to add additional costs to meet the required statutory and legal obligations once we have formally agreed to take on the Isles of Scilly.
11. We understand the need to be able to recover the costs if the level of investments can be delivered in a more efficient and effective way however as we continue to state the Isles of Scilly are a special case and we would ask that the business plan Isles of Scilly submission costs are ring fenced and that we use our WaterShare framework to monitor delivery and any gains are effectively shared back to customers at an enhanced sharing rate rather than disallowing costs from this unique investment up front. This would allow us to work with all our Regulators to understand the extent of the issues on the Isles so that they are afforded the service and protections that customers on the mainland receive.
12. We would like Ofwat to consider how to treat the Isles of Scilly which will include ongoing dialogue on the cost, using the Watershare framework to monitor delivery and provide enhanced sharing rates with customers in the event that the investment profiled over the five years is delivered for less than the original assumptions. If the Isles of Scilly are treated in this way, we believe that the performance commitment should be removed as it will double count the financial incentives/share to be returned to customers.

### **Internal sewer flooding enhanced outperformance rates**

#### We would like Ofwat to reconsider the Draft Determination intervention to reduce the enhanced outperformance incentive rates on internal sewer flooding

13. We consider our proposed internal flooding enhanced rate to be based on customers' views, appropriate and balanced and not an outlier compared to other companies enhanced rates. Furthermore, changes to the ODI incentive rate at this stage seems to be counter to the Early

Certainty Principle to which we have opted in. The change from IAP to DD removes £1m off outperformance a year.

#### *Customer views*

14. Our customers have told us that internal flooding is arguably the most extreme breach of service, and whilst customers consider our performance in this area to be good relative to other companies, it remains a key priority for our customers to do more to prevent internal sewer flooding, especially around repeat events.
15. Our customer valuation to prevent sewer flooding reflects customers' views that repeat internal flooding is intolerable. Our valuation evidence recognises that we have dealt with many internal sewer flooding issues and often it is the most expensive and severe cases of internal flooding that remains.
16. We thoroughly tested our customer valuations for reducing sewer flooding with customers and with the WaterFuture Customer Panel as part of our triangulation process. The enhanced rate applied to this valuation is also based on customer evidence. This analysis showed the value of the standard rate should be £6m per unit, and the value of the enhanced rate should be £12.4m per 10,000 sewer connections.
17. We accept Ofwat's view that standard incentive rates for the common PCs should more closely align – and we support the proposed change in the incentive rate in this area to £3.52m per 10,000 sewer connections. However, we do not consider a proportionate reduction in the outperformance enhanced rate to be required.
18. Maintaining the enhanced rate at our proposed £12.4m per 10,000 sewer connections aligns with customers' views on the importance of driving improvements in the internal flooding metric, and the overall package of incentives (RORE range). Lowering this would move us away from our customers' views on the right level of incentives we should have in our business plan.

#### *The recommended industry approach to estimating enhanced rates*

19. A step change in industry frontier performance in this metric requires considerable innovation and investment. The benefits to our customers – and the rest of wastewater customers through our sharing of our approaches, processes and knowledge – will be significant.
20. Maintaining our enhanced rate would mean the enhanced rate multiplier (i.e. the ratio of our standard to enhanced incentive rate for outperformance) will be 3.5. As shown below, this is a reasonable and proportionate multiplier, which will provide strong incentives to drive truly leading sector performance in this key metric.

21. We note the 2017 Frontier Economics<sup>1</sup> prepared for Ofwat provides industry guidance that enhanced rates need to reflect company size and the customer value of investment and innovation.
22. A further publicly available 2018 Frontier Economics<sup>2</sup> was commissioned by a water company to further clarify the principles and demonstrate appropriate enhanced rates in line with the 2017 report for Ofwat. The Frontier Economics, 2018 report notes:
- “This multiplier would need to reflect two factors.*
- *First, the size of the water company relative to the industry size. The smaller the company relative to the industry, the greater the ratio between:*
    - o *The customers in other companies to benefit from improvements in sector performance; and*
    - o *The own customer base that pays the standard incentive rate.*
  - *Second, the company’s customer valuation of the measure relative to the valuation of customers of other companies. The more customers of other companies value this metric compared to the company’s own customers, the more they will benefit from improvements in sector performance.”*
23. It is clear from other companies’ business plans, and the value of the standardised rate applied by Ofwat across the industry, that all customers of wastewater companies value this metric highly. Extract from 2018 report:

**Figure 4 Calculation of the multiplier for sewage services (unadjusted)**

| Company                      | Total number of properties connected to sewerage services | Unadjusted multiplier |
|------------------------------|---|-----------------------|
| Anglian Water Services       | 2,683,041   | 9.03                  |
| Dwr Cymru Cyfyngedig (Welsh) | 1,416,267   | 17.10                 |
| Northumbrian Water Ltd       | 1,242,969   | 19.49                 |
| Severn Trent Water Ltd       | 3,947,510   | 6.14                  |
| South West Water Ltd         | 711,701   | 34.03                 |
| Southern Water Services Ltd  | 1,919,628   | 12.62                 |
| Thames Water Utilities Ltd   | 5,640,021   | 4.29                  |
| United Utilities Water Plc   | 3,228,703   | 7.50                  |
| Wessex Water Services Ltd    | 1,197,968   | 20.22                 |
| Yorkshire Water Services Ltd | 2,233,735   | 10.84                 |
| Total                        | 24,221,543  |                       |
|                              | Maximum   | 34.03                 |
|                              | Minimum   | 4.29                  |

Source: 2012-13 data from Ofwat’s PR14 feeder models; domestic and non-domestic properties. Includes properties receiving sewage only services and properties receiving water and sewage services.

24. Frontier Economics compute the enhanced rate multiplier for all wastewater companies based on their size and similar standard valuations. This shows the minimum enhanced rate multiplier should be 4.3, and the SWW an enhanced rate multiplier should be much higher (estimated at 34) – prior to applying any relevant adjustments that reflect time delays of benefits being transferred, the ability of other companies to replicate innovation, and the need for rates to be proportionate and balanced.

<sup>1</sup> Frontier Economics (2017). “Performance Commitments and Outcome Delivery Incentives at PR19: A report prepared for Ofwat” 28 March 2017

<sup>2</sup> Frontier Economics (2018). “Enhanced Incentives: A note prepared for Anglian Water”, May 2018.

25. Whilst we would recognise a multiplier of this magnitude is disproportionate and out of line with our customers' views – it does highlight that that if we drive a step change in frontier performance, the wider benefits of sharing our innovations, processes and approaches would be very substantial and should be encouraged.

#### *Other companies' rates*

26. We have noted other companies proposed enhanced rates. The multipliers proposed in September 2018 business plans was generally in the range 1.5 to 5 (this excludes very high outlier rates such as those proposed by Yorkshire Water), with an average multiplier of 3-4. Hence our proposed enhanced rate for this metric is in line with other companies' proposals for enhanced rates.

#### *Early Certainty Principle*

27. A final - and important - point is around the Early Certainty Principle. We have agreed to opt in to the Early Certainty Principle. This states that there will be no changes to the ODI incentive rates; changing the internal flooding enhanced rate seems to be counter to this principle.

28. We note that Ofwat indicated in its initial assessment of plans that it would continue to protect customers by not applying the Early Certainty Principle if a company's outperformance payment is the highest, or the underperformance penalty rate was the lowest of all the companies.

29. Our review of other companies' business plans shows that our standard and enhanced outperformance rates for internal flooding are not industry outliers, as shown in the table below:

**Internal flooding ODI rate: £m per 10,000 sewer connections**

| £m per unit | Out performance rate | Under performance rate | Enhanced outperformance rate | Enhanced under performance rate |
|-------------|----------------------|------------------------|------------------------------|---------------------------------|
| UU          | 2.200                | -8.275                 | -                            | -                               |
| SVT         | 18.720               | -22.602                | 28.080                       | -33.904                         |
| SWW         | 3.520                | -9.512                 | <b>12.4 / 7.0</b>            | -19.024                         |
| Wessex      | 7.1                  | -11.9                  | 31.0                         | -51.0                           |
| Yorkshire   | 8.435                | -8.435                 | 14.873                       | -21.311                         |
| Anglian     | 10.994               | -21.122                | -                            | -                               |
| NWL         | 1.976                | -2.543                 | -                            | -                               |
| Southern    | 5.557                | -5.557                 | -                            | -                               |

|        |        |         |   |   |
|--------|--------|---------|---|---|
| Thames | 16.762 | -21.635 | - | - |
| Welsh  | 0.3044 | -1.8322 | - | - |

30. Therefore, under the Early Certainty Principle it does not seem appropriate to change the enhanced outperformance rate

31. We consider our proposed enhanced outperformance rate to be appropriate and in line with the agreed Early Certainty Principle. It fully reflects customers' valuation for this metric, and the benefits of sharing our innovation with the rest of wastewater customers and will give strong incentives to deliver for our customers in this important aspect of service.

**Alderney and Knapp Mill delivery timescales**

We would like Ofwat to note that the timing of delivering the schemes has switched

32. We have introduced ODIs to drive efficient delivery of Alderney and Knapp Mill water treatment works. However, as indicated in our business plan discussions the timing and ordering of the investment with the DWI was not complete. These are now complete and the company and DWI have agreed that Alderney WTW should be completed first, with Knapp Mill starting and completed second. Alderney completion date will be 31 March 2025. Knapp Mill will be 31 March 2027.

33. A summary of the updated PC levels is given below:

**Table 1 - PC levels:**

|            | 2020-21  | 2021-22  | 2022-23  | 2023-24  | 2024-25   | 2025-26  | 2026-27   |
|------------|----------|----------|----------|----------|-----------|----------|-----------|
| Alderney   | Underway | Underway | Underway | Underway | Completed |          |           |
| Knapp Mill | -        | -        | Underway | Underway | Underway  | Underway | Completed |

34. We are not proposing to submit new cost claims for Alderney and Knapp Mill as the expenditure profile for AMP7 with the efficiency challenge applied is broadly the same.