

A decorative graphic consisting of a vertical line on the left side, a horizontal bar at the bottom, and a vertical line on the right side. The bar is divided into three colored sections: green on the left, blue in the middle, and light blue on the right. The vertical lines are dark green and blue respectively.

**South West Water**  
**Business Plan Update 2015-20**  
Ofwat's Draft Determination

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## What is this document?

This document summarises key points from Ofwat's Draft Determination published on 30th April 2014, for the five years from 1 April 2015 - 31 March 2020.

[southwestwater.co.uk/waterfuture](http://southwestwater.co.uk/waterfuture)

# South West Water

## Business Plan Update 2015-20

### Ofwat's Draft Determination

## Highlights

Benefits of enhanced assessment:

- Initial financial award: £11m addition to Regulatory Capital Value (RCV), up to 50% to be reinvested
- Enhanced Totex menu provides for 5% additional sharing rate
- Below baseline cost assessments for both water and wastewater services - additional revenue allowances recognised
- "Do no harm" principle to Final Determination
- Early certainty enabling delivery

- Proposed legacy adjustments accepted
- Proposed uplift to ACTS for bad debts accepted

Equity returns in line with previously published risk and reward guidance

Equity returns of 10% for outperformance:

Base returns	5.7%
Cost base	2.2%
Outcome delivery Incentives	1.6%
Financing	0.5%
<b>Total</b>	<b>10.0%*</b>

\* Before enhanced financial awards

Customer tariff freeze in 2014/15; revenue smoothing into K6 (2015-20), NPV smoothing

- Agreed through legacy adjustments

South West Water planned K6 capital programme 19% higher<sup>(1)</sup> than K5 at £868m

Average household bills below inflation to 2020:

- 13% real reduction from 2014
- 7% real reduction from 2015

South West Water Appointee planned expenditure £1,697m, Ofwat allowed expenditure £1,741m

<sup>(1)</sup> 2012/13 price base.

# Executive summary

**We published our 2015-20 business plan on 2 December 2013. The plan describes the improvements we want to deliver to water and wastewater services in our region in order to meet our customer and stakeholder priorities and, in doing so, continue to support our unique region and environment.**

**On 4 April 2014, Ofwat awarded enhanced status to our business plan following the completion of their risk-based review.**

We are pleased Ofwat acknowledged that we had produced a high quality business plan which **“stood apart from other companies”**. Ofwat commended South West Water on **“achieving enhanced status through an excellent business plan and strong management.”** They also stated South West Water has: **“risen to the challenge set by the regulatory approach for the 2014 price review. They have developed a business plan which can be considered by other companies as an example of good practice”**.



Ofwat also stated that our plan:

- **Has a strong focus on engagement**
- **Focus[es] on affordability and efficiency, through the use of new technology, partnership working and innovative approaches**
- **Stood out because of a desire to build legitimacy with its customers... demonstrated... through its engagement with customers... also through its approach to measuring and sharing performance over 2015-20**
- **Contains a Board pledge to share the benefits of success fairly between customers and investors. In line with this it is proposing an independently monitored and transparent performance sharing framework called ‘WaterShare’**
- **Met [their] expectations in relation to Board assurance, with [the South West Water] Board’s view that the plan is high quality being supported by evidence and data from the rest of the plan.**



We have worked hard to develop a balanced plan that will deliver the best outcomes for our customers, the environment and the region. Ofwat’s assessment of our plan as high quality is further recognition of this.

Our plan has been positively received by our customers and stakeholders. Overall customer acceptance for our proposals achieved a strong 84%.

Our performance commitments to deliver improvements to service in the areas which matter most to customers are also fully supported by our independent WaterFuture Customer Panel and environmental and quality regulators.

Our strategy is designed to ensure we are as efficient as possible, making the most of our resources and exploiting new technologies and ways of working that represent cost-effective long-term solutions.

**Generating a fair return for investors is a vital part of our business model. We are including a new incentive framework that allows for higher returns if we deliver more.**

On 30 April we received a Draft Determination from Ofwat which is aligned with our business plan objectives.

Ofwat stated:

**“Our Draft Determination reflect[s] the [company’s] updated business plan, which [is] in line with what we set out in... our risk and reward guidance”**.

We will receive financial benefits, through an initial reward of £11m and access to enhanced cost performance menus, reflecting the benefits of a high-quality business plan to current and future customers.

As a result of finalisation of the wholesale cost baseline and menu design, the enhanced menu benefit for K6 is circa 50% of the £6m Ofwat announced at the pre-qualification for enhancement announcement. This reduction is more than offset by the initial 2015-20 £8m upfront revenues from the menu. Revenues will be increased by a further £19m in K7 if the South West Water expenditure is as per the plan.

As an enhanced company we will also benefit from a “do no harm” principle ensuring we will not be disadvantaged by receiving our Draft Determination at an earlier stage than other companies. The benefits of reaching this part of the process and focusing on implementation of the business plan cannot be underestimated.

Furthermore, we now gain the reputational advantages of enhanced status, as well as a fast-track through the price review process. This benefits us, our customers and investors by providing significantly greater clarity and certainty, enabling us to begin to deliver our Business Plan now.

## Key financial highlights

Appointee Totex	K6 <sup>(1)</sup>
South West Water Business Plan Totex	£1,697m
Draft Determination allowed Totex	£1,741m

- The difference between the South West Water plan Totex and Draft Determination allowed Totex represents an efficient position on the menu

Implied efficiency (Totex and ACTS) <sup>(1)</sup>	K5	K6
Operating costs	2.8%	2.5% <sup>(2)</sup>
Capital expenditure	5.0%	5.5%

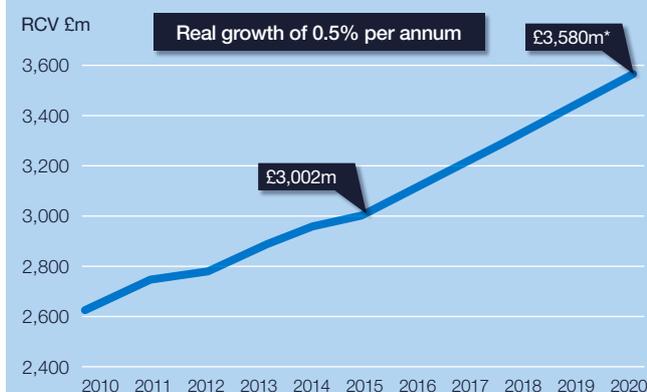
- No change to South West Water proposed cost efficiency challenge
- Maintaining the pace from K5
- Benchmarked cost assumptions

Investor highlights	K5 <sup>(1)</sup>	K6 <sup>(1)</sup>
Wholesale vanilla cost of capital	5.1%	3.7%
Retail margins (RCV returns equivalence)	-	0.2%
Cost of equity	7.1%	5.7%
Cost of debt	3.6%	2.8%
Notional gearing	57.5%	62.5%
Return on Regulated Equity (RoRE)	-	2-10%*
Financeable	✓	✓

- Returns mirror Ofwat's risk and reward guidance
- Wholesale returns - reflective of empirical evidence
- Retail margin - profit margin of 1.0% for households, 2.5% for non-households
- RoRE - fair risk and reward balance
- Financeable - required financial covenants and ratios met
- Affordable bills reducing in real terms and in nominal terms less than headline RPI

\* Before the impact of enhanced financial position.

## Shareholder value<sup>(3)</sup>



- RCV growth of 19% from £3.0bn to £3.6bn
- Change in RCV (2020, outturn prices)

December plan RCV in 2020	£3,545m
Enhanced Status award	£11m
Additional allowed revenue net of run off	£24m
Draft Determination RCV in 2020	£3,580m

\* Includes £11m financial award and assumed Totex menu position.

<sup>(1)</sup> 2012/13 price base.

<sup>(2)</sup> No material impact arising from Ofwat's bad debt challenge.

<sup>(3)</sup> At outturn price assuming 3.2% RPI.

# Key revenue building block components

## Appointee

### Allowed revenue summary

This table below identifies profiled expenditure included within the building blocks in the allowed revenue for the Appointee business as determined by Ofwat.

The average bills reflect the revenue allowance adjusted for customer demand, new connections and the impact of customers switching to a metered supply.

Appointee - Outturn prices (2012/13 price base inflated by 3.2% per annum)	2015/16 £m	2016/17 £m	2017/18 £m	2018/19 £m	2019/20 £m
PAYG (operating costs and IRE)	230.7	232.0	230.5	238.3	244.1
Pension deficit repair costs	9.0	9.3	9.5	9.8	10.1
Depreciation (determined by RCV run-off and post 2015 depreciation)	135.3	142.1	149.8	158.0	167.1
<b>Financing costs</b>					
Return on RCV	112.7	116.9	121.3	125.8	130.5
Retail margin - Household (net of tax)	3.2	3.3	3.4	3.6	3.6
Retail margin - Non-household (net of tax)	2.8	2.8	2.9	3.0	3.1
Tax	19.4	19.0	17.3	13.0	10.4
<b>Revenue adjustments</b>					
Legacy adjustments	(11.5)	(10.3)	(3.6)	(3.8)	(3.9)
Additional menu income	1.9	1.9	2.0	1.9	2.0
Infrastructure charges and capital contributions net of miscellaneous income	(0.1)	0.2	0.3	0.4	(0.2)
<b>Draft Determination allowed revenues</b>	503.4	517.2	533.4	550.0	566.8
Change in allowed revenue from previous year (before wholesale inflation)		(0.2%)	0.2%	0.1%	0.1%
<b>Key financial metrics</b>					
Totex - wholesale and retail (including pension deficit repair costs and gross Capex)	394.7	410.5	417.8	426.4	445.7
PAYG ratio	57.9%	55.8%	54.3%	55.3%	54.0%
Regulatory Capital Value (RCV) - year end	3,091	3,209	3,332	3,452	3,580
<b>Customer bills</b>					
Average household bill (before £50 government payment)	535	547	560	573	586
Average household bill (including £50 government payment)	485	497	510	523	536

# Key revenue building block components

## Wholesale

### Cost assessment and menu position

The menu position is shown below:

2012/13 prices	Water	Waste water	Total
Total allowed expenditure	£727m	£899m	£1,626m
South West Water Plan Totex	£683m	£896m	£1,579m
Plan – menu position (SWW plan vs Ofwat baseline)	91.5%	99.6%	96%
Cost incentive sharing rate	56.7%	55.1%	55.8%
Initial incentive reward for 2015-20	£7.8m	£0.4m	£8.2m
Additional allowed expenditure to SWW plan for 2015-20	£44m	£3m	£47m

The enhanced Totex menu provides for 5% additional menu sharing rate. The cost incentive sharing rate for 2015-20 is 56.7% for wholesale water and 55.1% for wholesale wastewater.

- Both wholesale water and wastewater cost assessments are below Ofwat's "upper quartile" baselines (a Totex menu position of 100), and are therefore confirmed by Ofwat as efficient.
- Water efficiency is 91.5% of the Ofwat baseline which results in additional allowed expenditure of £44m and £7.8m enhanced menu incentive reward.
- Wastewater efficiency is 99.6% of the Ofwat baseline which results in additional allowed expenditure of £3m and £0.4m enhanced menu incentive reward.

- The Draft Determination wholesale cost menu baseline differs from the risk-based review thresholds previously published because Ofwat has applied South West Water actual activity forecasts.
- South West Water plan costs were £116m (circa 7%) below the risk-based review threshold. The plan costs are £63m below for the Draft Determination (circa 4%).
- The menu position provides for £47m additional expenditure to the South West Water plan, of which £23m enhances allowed revenue during 2015-20 (reflecting the 'Pay as you go' (PAYG) fast money share of circa 50%), and £24m enhances the RCV. These allowances are in addition to the South West Water plan assumptions.
- The baseline adjustments in the Draft Determination are being reviewed.

### Capital charges and fast/slow money

The Draft Determination contains PAYG fast money allowed revenue rates (with minor adjustments to depreciation allowance rates) to reflect:

- the additional allowed expenditure associated with the efficient position on the Totex menu
- the split of the additional allowed expenditure between cost recovery "in period" (i.e. PAYG and depreciation) and the RCV (to earn a rate of return)
- technical adjustments, such as the treatment of infrastructure charges for the Totex menu.

# Key revenue building block components

## Wholesale

### Legacy adjustments

The Draft Determination reflects the following legacy revenue adjustments. The Final Determination will be updated for any material changes arising from actual performance in 2013/14 and updated forecasts for 2014/15:

Draft Determination, 2012/13 prices	£m
Operating cost outperformance (OIA)	+£1.5m
Revenue correction mechanism (RCM)	(£3.3m)
Service incentive mechanism (SIM) (-0.5% penalty)	(£14.4m)
Capital expenditure incentive scheme (CIS)	(£13.8m)

### Operating cost outperformance (OIA)

OIA will be updated to reflect actual 2013/14 expenditure once this is finalised. K5 efficiencies have been front end loaded for delivery and are forecast to retain this performance to the end of K5.

### Revenue correction mechanism (RCM)

The revenue correction mechanism incorporates the impact of the price freeze for 2014, which smoothes out the change to customers bills over 2014-20, reducing the impact of this legacy adjustment. This approach has avoided a material impact on shareholder value.

### Service incentive mechanism (SIM)

The SIM penalty was based on 2011/12 and 2012/13 performance. The final adjustment will consider any material changes from 2013/14 as the incentive applies over the three year 2011-2014 period.

South West Water SIM performance continues to improve, with the final adjustment affected by relative performance compared to other companies.

### Capital expenditure incentive scheme (CIS)

The CIS combines two components within the total revenue legacy adjustment.

An outperformance award of £3.6m and a financing adjustment to be returned to customers of £17.4m (reflecting the 5% outperformance targeted in K5).

The outperformance reward reflects expenditure below that included in the 2009 Final Determination, based on the menu position at the time. We have outperformed on both net and gross capital expenditure compared to 2009 Final Determination by 5%.

This produces a financing adjustment of £17.4m to reflect the lower incurred expenditure, and the financing benefits received in K5.

Ofwat has accepted the logging up of private sewers and bathing water expenditure without adjustment.

### Capital investment

Overall Totex expenditure levels allowed by the Draft Determination means that our planned investment programme in K6 is unchanged at £868m (gross including IRE). This compares to £730m in K5 (2012/13 price base). Details of the investment programme can be found in our 'Investor Summary' published on December 2013.

# Key revenue building block components

## Retail

### Retail household

Ofwat has accepted our household retail costs, including the adjustment to the industry Average Cost to Serve for bad and doubtful debt. The adjustment of £34m is circa 25% of the allowed cost to serve of £143m for 2015-20.

Ofwat recognised (and confirmed with their own modelling) the adjustment was required to reflect high bill levels in the South West. This was on its own not sufficient for Ofwat to make an adjustment and we were pleased that Ofwat acknowledged that our management practices were efficient and that the level of the proposed adjustment reflected those management practices.

Ofwat reported that we had provided strong evidence in relation to bad debt and that this was in line with a qualitative review of good practice in the management of bad debt costs. Similarly, in relation to bill levels, Ofwat's assessment in other parts of the risk-based review demonstrated that we had costs which were efficient.

South West Water had included a glidepath between current debt levels and the adjusted level in our original plan, which we accepted was not required for the Draft Determination. This equated to £3.5m.

### Household retail margin

The Draft Determination assumptions are:

- a retail margin of 1.0% on the wholesale charges and retail costs and equates to an average £3.8m per annum.
- the recalculation of allowed household revenue incorporates the cost base presented by South West Water (adjusted for revenue of £3.5m glidepath). The allowed per customer cost to serve represents the cost base required.

### Non-household retail margin

The Draft Determination assumptions are:

- non-household margin of 2.5%
- the margin is applied to wholesale and retail costs and equates to circa £3.3m per annum additional revenue
- 1.5% of net margin is additive to the appointee WACC of 3.85%.

Bad debt charge	Total £m
South West Water bad debt adjustment	34.0
Ofwat industry average bad debt allowance	33.0
Total bad debt charge	67.0

# Key revenue building block components

## Returns

### Investor returns

Returns for investors are derived from both the wholesale and retail revenue controls. Overall returns are set out in the table below.

Overall returns - as per risk and reward guidance	Wholesale vanilla cost of capital/retail profit margins	Return on RCV (post tax) and retail equivalent
Wholesale	3.7%	3.7%
Household retail net margin	1.0%	0.15%
Non-household retail net margin	2.5%	0.05%
Total Returns		3.90%

The expected equity return of 5.7% and RoRE range of (2% - 10%) is based on South West Water plan costs assuming these are aligned with Ofwat's baseline. With the enhanced awards and the implied menu position, the RoRE will increase further.

**Investors take risk** investing in the business and a **fair level of return** is required to reflect this

# Key revenue building block components

## Returns

### Appointee returns

Ofwat has applied returns in line with their risk and reward guidance, accepted by South West Water.

Cost of capital	Draft Determination
Industry cost of debt	2.75%
Cost of equity	5.65%
Gearing	62.5%
Tax	20.0%
Wholesale WACC (vanilla)	3.85%

Cost of equity	Draft Determination
Risk-free rate	1.25%
Equity risk premium	5.5%
Asset beta	0.3
Equity beta (62.5% gearing)	0.8
WACC vanilla (including retail margins)	3.85%
Cost of equity	5.65%

# 10%

**Equity returns for outperformance**

# Performance monitoring & sharing

Our Business Plan contains a Board pledge to share the benefits of success fairly between customers and investors. In line with this our proposed new performance sharing and independently monitored reporting framework 'WaterShare' represents an evolutionary step to greater transparency and openness.

The WaterShare framework allows for sharing of excellent performance and potential gains in a timely manner with customers. We also believe that an approach that allows risks to be clearly articulated when they manifest themselves and describes how the company intends to manage them is critical for customer and shareholder confidence in our business.

We have developed a new framework that:

- **calculates and apportions between customers and stakeholders:**
  - good performance over and above commitments and expectations
  - other areas of risk and opportunity
- **appropriately shares net benefits to customers, or highlights clearly the requirement for regulatory assessment of a net pain position**
- **reports and tracks annually performance.**

The WaterShare framework will allow customers and shareholders to potentially gain 'in period' from:

- **outperformance of targeted cost base efficiency**
- **bettering our performance commitments in relation to outcomes**
- **other areas of risk and opportunity.**

We also consider it important that when new obligations (legislative requirements) may result in additional costs for our business, this is articulated clearly to our customers.

This framework will involve the publication of a scorecard on an annual basis that summarises our performance and will allow for the sharing of net benefits with customers in a timely manner.

## Example summary scorecard

2018/19	TOTAL	CUSTOMER	SHAREHOLDER
<b>WaterShare</b>	→	↓	↓
<b>PERFORMANCE</b>	Cum. £m	Cum. £m	Cum. £m
Driving cost base efficiency	1		
Other factors	2		
Delivering outcomes	3		
Net position			

**Sharing for customers translates into lower bills and improved services**

**Sharing for shareholders translates into higher profits and larger dividends**

## 1 Cost base outperformance

We have targeted at least a 2.5% per annum operational cost and 5.5% overall capital cost efficiency on our cost base for 2015-20. Where we deliver greater efficiency, both shareholders and customers will benefit.

Our enhanced status offers an increased Totex sharing factor for shareholders of circa 55% which will be added to the 2020 RCV as a 'true-up' at the end of the period.

## 2 Other factors

There are many assumptions made in developing a business plan. We think it is appropriate that where certain assumptions turn out to be different, customers share in any net 'gains'.

In accepting the risk and reward guidance we have included uncertainty mechanisms for water cumulo business rates and relevant changes of circumstance (RCC).

Examples of these areas are:

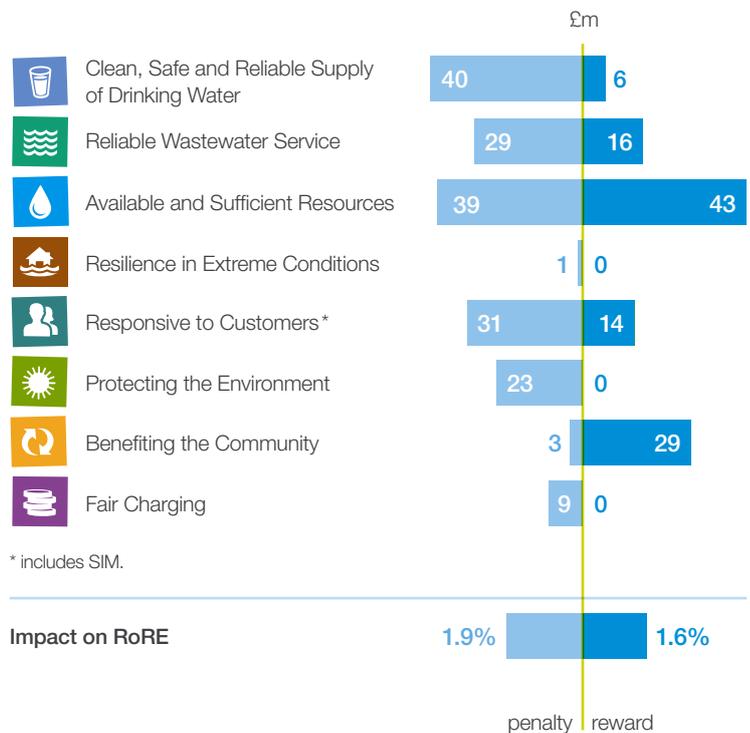
- changes in taxation rates
- changes in the industry assumed cost of new debt.

## 3 Outcome delivery incentives (ODIs)

The outcomes in our Business Plan reflect the priorities and outcomes we developed in conjunction with our customers and the WaterFuture Customer Panel.

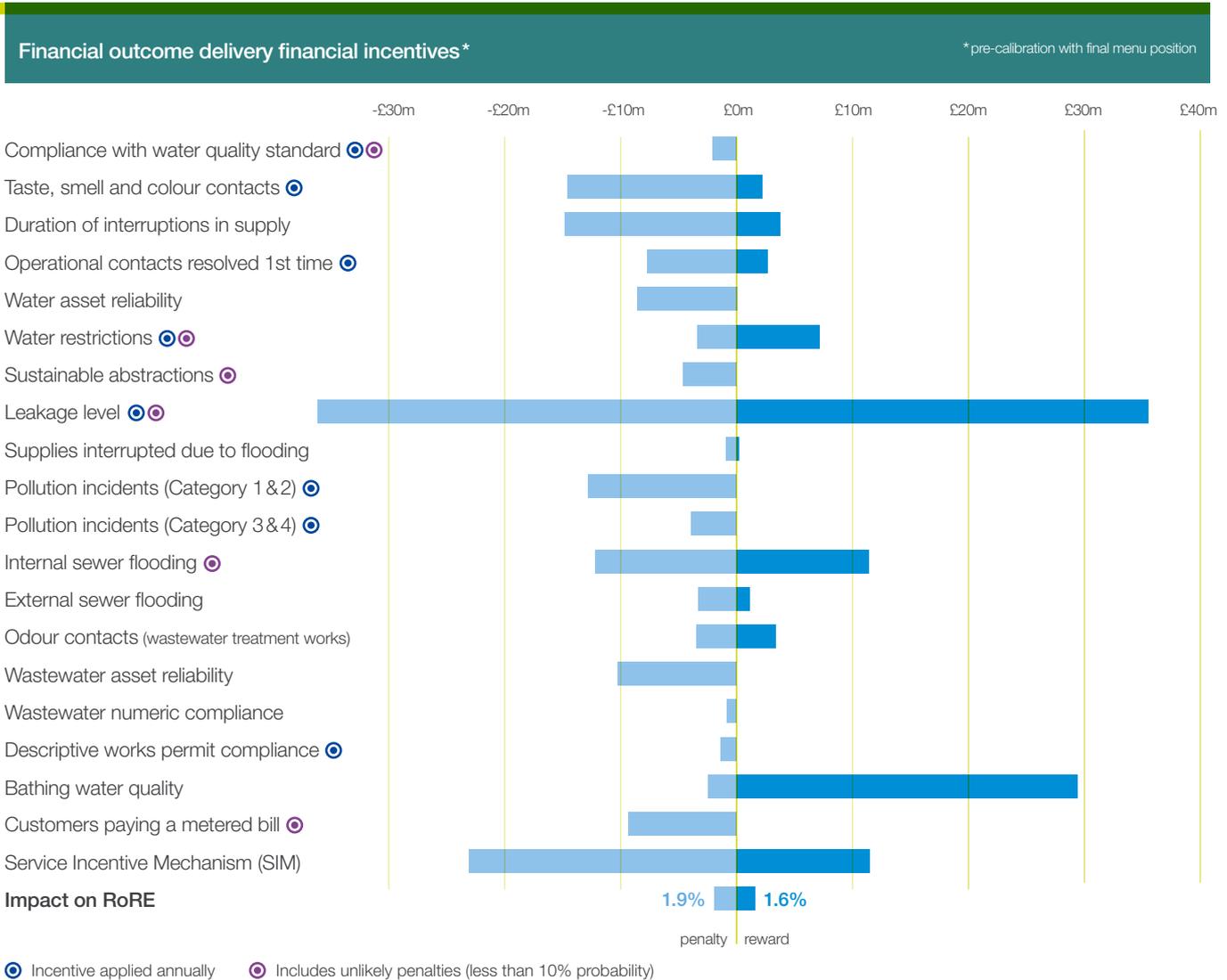
Our performance in the delivery of the outcomes is a key component of WaterShare. As described in our December Business Plan, we have established measures of success and performance commitments for all eight outcomes, along with specific incentives for delivery. The successful delivery of the outcomes will result in benefits which will be shared between customers and shareholders.

We have summarised the outcome delivery incentives grouped by outcome opposite.



# Performance monitoring & sharing

As well as summarising the ODIs at outcome level, we have summarised them at measure level below. The overall incentive ranges from penalties of £175m to rewards of £108m (including SIM).



Our ODIs are designed to drive the right behaviours, encourage innovation and service improvement and support the successful delivery of customer and stakeholder priorities. Our ODI framework consists of a package of financial and reputational incentives, with the former illustrated above along with their potential reward and/or penalty range for the 2015-20 period.

Our plan includes a balanced range of penalty only and reward and penalty ODIs. Rewards are focused in areas which are top priorities for customers, including water restrictions, leakage, bathing waters, customer service and prevention of internal sewer flooding.

The penalty ODIs are designed to replicate existing penalty mechanisms and to penalise exceptionally poor performance in areas such as drinking water quality and pollutions.

ODIs are either applied through 'in period' adjustments to revenues or through adjustments to the RCV at the end of the period. Broadly the ODIs are evenly split between the two.

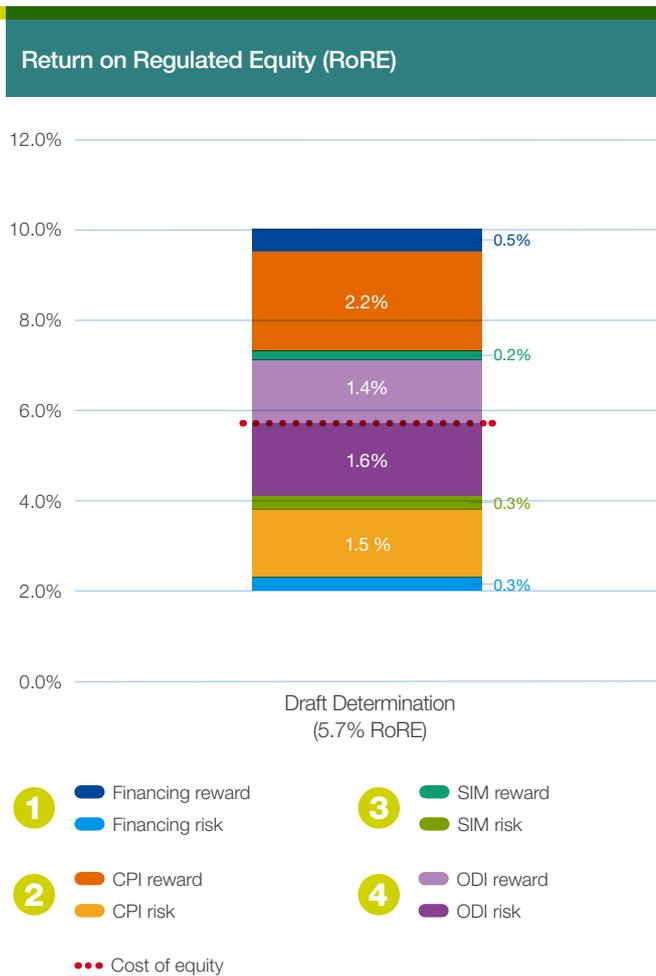
Caps, collars and deadbands will also be applied to allow for the normal variations in performance – for example the impact of weather events.

# Performance impacts on equity returns

We have balanced the needs of our customers and investors so that investors are not rewarded solely on the basis of allowed cost of capital and retail margin, but also have the opportunity to earn additional rewards through us being more efficient or by delivering a higher level of performance where this is valued by customers. Equally, incentive penalties will affect returns.

Ofwat accepted our proposed risk and reward package which provides more incentive for outperformance than there has been at previous price reviews.

Overall the Draft Determination Return on Regulated Equity (RoRE) range is aligned with our original plan of 2% to 10% (excluding enhanced rewards and menu incentives).



The individual RoRE components are described below.

**1** Financing risk for a notionally geared company at the Ofwat cost of debt is estimated at a range of -0.3% risk and +0.5% opportunity within the RoRE range.

**2** Cost Performance Incentives (CPI) consider both individual cost risks and opportunities.

**3** SIM risk and reward ranges from a penalty of -1% of total revenue (-£23m) to +0.5% (+£11.5m). This is a RoRE range of -0.3% to +0.2% .

**4** ODIs provide for rewards for improvements in service levels beyond our central plan and industry norms. They amount to a potential total of £19m p.a., +1.4% of RoRE. ODI penalties for poor performance amount to a total of £30m p.a., of which £22m p.a. is within the normal range of performance considered in RoRE (-1.6%). Rewards and penalties have been reviewed for technical evidence and calibrated with Cost Performance Incentives since our original plan.

The RoRE range for each area represents the South West Water plan assumptions, with the financing RoRE impact reflective of a notional position.

# Next steps & timetable

In moving from the Draft to Final Determination, Ofwat will be considering:

- representations from companies and other stakeholders on Draft Determinations
- updated information submitted by companies as requested by Ofwat – for example, updated reported actual performance in 2013/14 and projected performance in 2014/15
- default tariff information
- policy that forms part of the wider price control package, which Ofwat will publish later in the price control process.

This process will allow time for South West Water to fully consider and respond to the various components of the price control framework in advance of Ofwat setting our Final Determination.

The development and refinement of our business plan has been characterised with extensive engagement with our customers, regulators and stakeholders including our WaterFuture Customer Panel. We will continue this engagement and dialogue as we approach the conclusion of the price review process.

As Ofwat confirmed in 'Setting price controls for 2015-20 – decisions on enhanced companies and next steps', we will not be disadvantaged by receiving our Draft Determinations at an earlier stage.





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