

# WaterFuture

## South West Water Final Determination 2020–25 Investor Summary



**South West**  
Water



**Bournemouth**  
Water

## What is this document?

This document summarises key metrics from Ofwat's Final Determination for South West Water published on 16 December 2019, for the five years from 1 April 2020 – 31 March 2025.

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# South West Water Final Determination 2020–25 (K7) Investor Summary **Key features**

**Totex allowance of c.£2 billion – in line with South West Water’s fast-track Draft Determination**

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**A suite of stretching but achievable ODIs reflecting the priorities of our customers**

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**An innovative sharing mechanism – WaterShare+**

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**A K7 capital investment programme of c.£1 billion**

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**Appointee cost of capital for the industry of 2.96% (CPIH), 1.96% (RPI)**

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**As a fast-track company, South West Water received a 10 basis point uplift to our base Return on Regulated Equity**

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**Base Return on Regulated Equity for South West Water of 4.3% (CPIH), 3.3% (RPI) incorporating an additional 10 basis points awarded for fast-track status.**

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## **Executive summary**

South West Water’s Final Determination for K7 was issued by Ofwat on 16 December 2019.

Having achieved fast-track status for two successive price reviews, the heart of our business plan remains the same, and we are committed to meeting the challenges, focus on delivering improvements and investing in the areas that matter most to our customers.

The benefits of the fast-track status has meant that delivery of key projects and improvements for K7 are already underway.

Whilst revenues have reduced, reflecting the re-based cost of capital allowance for the industry, the challenge to deliver the plan is one the Company is determined to meet.

## Executive summary

Investment programme <sup>1</sup> £m	K6 Expenditure 2015-20	K7 Final Determination 2020-25
Enhancement	258	289
Maintenance	592	700
<b>Total</b>	<b>850</b>	<b>989</b>

- Capital investment of c.£1bn in K7
- Two new water treatment works in the Bournemouth Water region
- Expansion to the Isles of Scilly
- Targeting investment in resilience alongside meeting our legislative obligations.

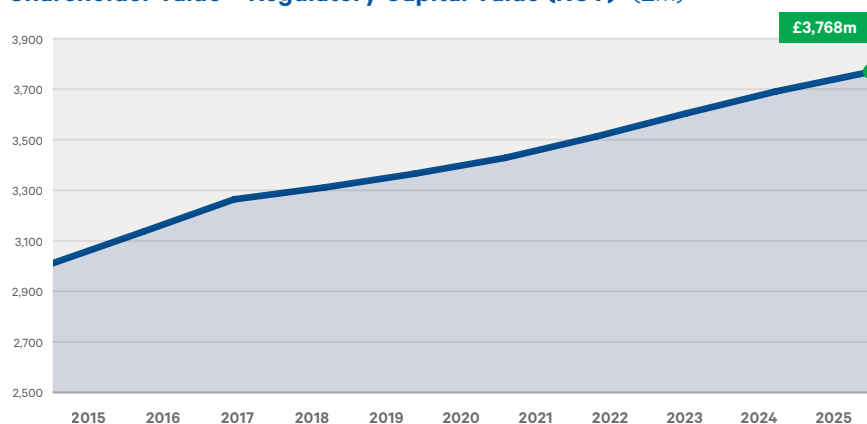
Appointee totex <sup>1</sup> £m	K6 Final Determination Allowance 2015-20	K7 Business Plan 2020-25	K7 Final Determination Allowance 2020-25
Gross totex	1,959	2,049	1,994
<b>Net Totex</b>	<b>1,924</b>	<b>1,978</b>	<b>1,910</b>

- Overall base costs deemed efficient (within c.3%)
- Gross totex (c.£2bn) in line with our Draft Determination
- Net totex includes grants and contributions for third party services.

Real returns based on:	K6 Final Determination 2015-20	K7 Final Determination 2020-25		Blended average (CPIH/RPI)
	RPI	RPI	CPIH	
Appointee vanilla cost of capital	3.85%	1.96%	2.96%	2.56%
Wholesale vanilla cost of capital	3.70%	1.92%	2.92%	2.52%
Residential retail margins	0.15%	0.04%	0.04%	0.04%
Equity return	6.00%	3.28%	4.29%	3.90%
Cost of debt	2.59%	1.15%	2.14%	1.74%
Notional gearing	62.5%	60.0%	60.0%	60.0%
Return on Regulated Equity (RORE)	+2.1% to +10.5%		-0.7% to +8.5%	

- Lower cost of capital for the industry, resulting in lower returns in K7
- Additional 10bps awarded for fast-track status on equity return.

### Shareholder value – Regulatory Capital Value (RCV)<sup>2</sup> (£m)

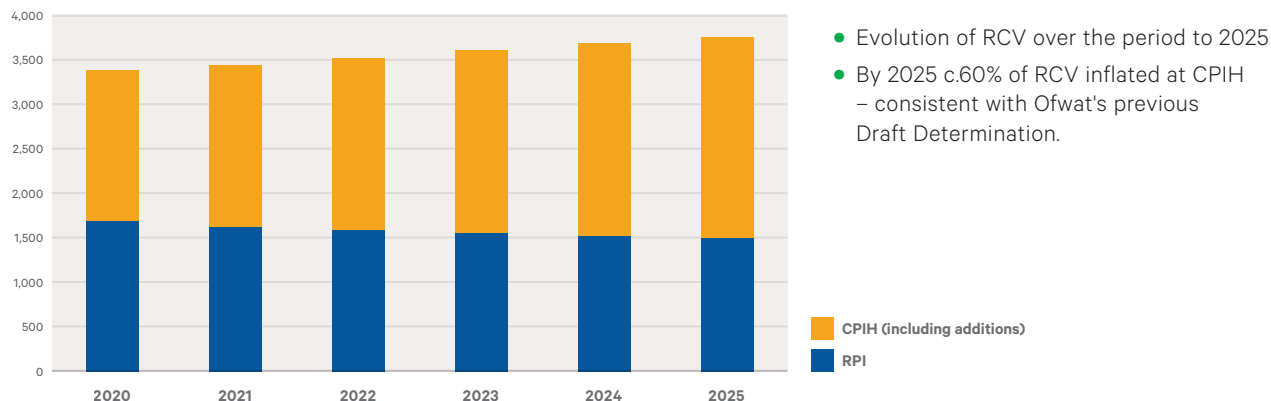


- c.11% nominal growth in RCV over K7
- K6 shadow RCV
- c.£300m totex outperformance delivered in K6.

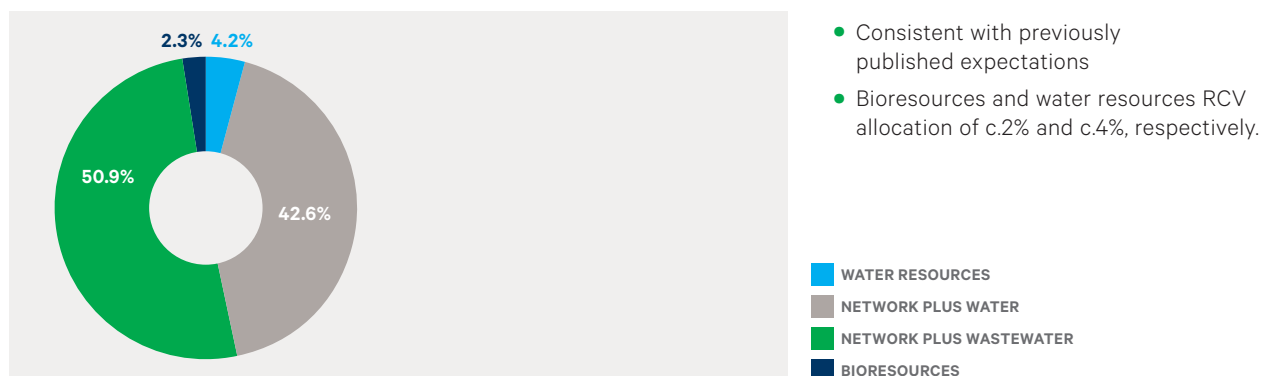
<sup>1</sup> 2017/18 prices – CPIH deflated

<sup>2</sup> 2015-19: outturn RPI used, 2020-25: using Ofwat Final Determination assumptions of inflation for K7.

### RCV allocation (£m)



### RCV allocation to revenue controls<sup>1</sup>



### Delivering an efficient service

The key areas of efficiency in the delivery in our business plan are focused in the following areas:

- Targeted innovative investment** – new cost effective water treatment works planned in the Bournemouth Water region, using cutting edge technology
- Operational ways of working** through our Resilient Service Improvement (RSI) project
- Energy procurement and usage** through targeted investment in energy efficiency and renewable energy generation schemes
- Retail cost efficiency** – continued focus on efficient service delivery through:
  - Smart metering strategy
  - Dual billing all unmeasured customers
  - Enhanced digital capabilities and streamlining of service.

- Cost of bad debt** – we have significantly improved collections through:
  - Development of our debt recovery system
  - Improved case resolution of high value debtors
  - Increased staff capacity, capability and retention
  - Reduction in previous occupier debt using third parties to trace customers
  - Increased affordability measures
  - Increased enforcement activity.

Continuation of these programmes is forecast to reduce the cost of bad debt on a similar scale by 2025.

<sup>1</sup> Average RCV over K7

# Key financials

## Allowed revenue summary

The table below identifies the costs included within the building blocks in the allowed revenue for the appointed business.

The implied average combined bill for both South West Water and Bournemouth Water reflects the revenue allowance adjusted for customer demand, new connections and the impact of customers switching to a metered supply.

Outturn prices <sup>1</sup> £m	K7 Final Determination 2020-25				
	2020/21	2021/22	2022/23	2023/24	2024/25
PAYG <sup>2</sup> (operating costs including retail and IRE <sup>3</sup> )	247.7	253.4	254.4	254.5	255.3
Pension deficit repair costs <sup>4</sup>	10.1	10.5	0.0	0.0	0.0
RCV run-off (including post 2020 additions)	173.3	176.0	179.1	182.5	185.3
<b>Financing costs<sup>5</sup></b>					
Return on RCV	82.8	85.2	88.0	90.7	93.2
Residential retail margin	4.0	4.0	4.1	4.1	4.1
Tax	15.8	15.6	17.2	16.7	16.1
<b>Revenue adjustments</b>					
Legacy adjustments	(5.6)	(5.9)	(6.1)	(6.4)	(6.8)
Other adjustments	(1.1)	(4.5)	3.6	2.9	3.8
<b>Final Determination allowed revenues</b>					
Total building block revenue	<b>527.0</b>	<b>534.3</b>	<b>540.3</b>	<b>545.0</b>	<b>551.0</b>
Grants & contributions	14.9	17.9	20.9	21.5	21.5
Other non-price control revenue	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)
<b>Total allowed revenue</b>	<b>541.6</b>	<b>551.9</b>	<b>560.9</b>	<b>566.2</b>	<b>572.2</b>
<b>Key financial metrics</b>					
Capital expenditure	194.6	204.1	209.4	207.2	201.3
PAYG ratio	58.3%	57.1%	56.5%	56.9%	58.6%
Regulated Capital Value (year end) <sup>6</sup>	3,455.7	3,533.1	3,618.5	3,699.6	3,768.2
<b>Implied average combined household bill (£)</b>	<b>458</b>	<b>449</b>	<b>439</b>	<b>430</b>	<b>422</b>

Key points to note are:

- PAYG and run-off rates reflective of underlying cost profiles and asset lives – consistent with our Draft Determination
- Pension deficit repair costs aligned with our agreed funding schedule
- Taxation reflective of a headline rate of 17% assumed in the Final Determination
- Legacy revenue adjustments reflect outturn for 2018/19 performance and are profiled over the period to 2025
- Other revenue adjustments include the element of fast-track reward added to revenue (in addition to an adjustment to RCV) and reprofiling to keep customer bills stable.

<sup>1</sup> Forecast outturn prices – Ofwat Final Determination assumptions of inflation for K7

<sup>2</sup> Pay as you go

<sup>3</sup> Infrastructure Renewals Expenditure

<sup>4</sup> End of Trustee agreed deficit recovery plan in 2022

<sup>5</sup> Based on notional 60% gearing

<sup>6</sup> Adjusted RCV uplift of c.£27m on average over K7 reflecting the IFRS16 adjustment previously omitted by Ofwat, the associated revenue increase of £12m will be trued-up at PR24.

## Key financials continued

Allowed revenue by control <sup>1</sup> £m	K7 Final Determination 2020-25					
	2020/21	2021/22	2022/23	2023/24	2024/25	K7 TOTAL
<b>Total building block revenue</b>						
Water Resources	20.4	20.3	21.2	21.3	21.7	104.9
Water Network Plus	216.5	220.6	224.8	225.7	230.4	1,118.0
Wastewater Network Plus	233.5	236.7	238.0	241.7	242.4	1,192.3
Bioresources	26.3	26.2	25.8	25.8	26.0	130.1
Residential Retail	30.3	30.5	30.5	30.5	30.5	152.3
	<b>527.0</b>	<b>534.3</b>	<b>540.3</b>	<b>545.0</b>	<b>551.0</b>	<b>2,697.6</b>
<b>Add: grants and contributions (price control)</b>						
Water Network Plus	7.4	9.0	10.5	10.8	10.7	48.4
Wastewater Network Plus	7.5	8.9	10.4	10.7	10.8	48.3
	<b>14.9</b>	<b>17.9</b>	<b>20.9</b>	<b>21.5</b>	<b>21.5</b>	<b>96.7</b>
<b>Less: other non-price control income</b>						
Water Network Plus	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(1.0)
Wastewater Network Plus	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.5)
	<b>(0.3)</b>	<b>(0.3)</b>	<b>(0.3)</b>	<b>(0.3)</b>	<b>(0.3)</b>	<b>(1.5)</b>
<b>Total allowed revenue</b>						
Water Resources	20.4	20.3	21.2	21.3	21.7	104.9
Water Network Plus	223.7	229.4	235.1	236.3	240.9	1,165.4
Wastewater Network Plus	240.9	245.5	248.3	252.3	253.1	1,240.1
Bioresources	26.3	26.2	25.8	25.8	26.0	130.1
Residential Retail	30.3	30.5	30.5	30.5	30.5	152.3
	<b>541.6</b>	<b>551.9</b>	<b>560.9</b>	<b>566.2</b>	<b>572.2</b>	<b>2,792.8</b>

## Legacy adjustments

Adjustments to the opening RCV reflect totex outperformance shared with customers and shareholders, Outcome Delivery Incentive (ODI) outperformance over K6 and industry-wide legacy adjustments (CIS<sup>2</sup> RCV inflation correction).

£m <sup>3</sup>	K7 Final Determination 2020-25
<b>Closing RCV – 31 March 2020</b>	<b>3,575.0</b>
Totex	(161.3)
Outcome Delivery Incentives	9.8
CIS RCV inflation correction	(45.7)
Other, including land sales	(12.4)
Fast-track award	2.8
IFRS16 adjustment	28.8
<b>Opening RCV – 1 April 2020</b>	<b>3,397.0</b>

- Opening RCV has been reduced by the customer sharing element of totex outperformance in K6 of c.£300m
- Successful delivery of ODIs in K6 is added to the opening RCV for K7
- CIS inflation adjustments reflect an industry wide true-up from assumptions made in PR14
- IFRS16 adjustment to increase the RCV recognises the omission of data not included by Ofwat in South West Water's Final Determination for K7.

<sup>1</sup> Forecast outturn prices – Ofwat Final Determination assumptions of inflation for K7

<sup>2</sup> Capital Incentive Scheme

<sup>3</sup> Forecast outturn using Ofwat assumptions for inflation at 31 March 2020.

## Key financials continued

### Investor returns

The cost of capital has been reduced from 3.85% at PR14 to 1.96% (1.92% at the wholesale level) on an RPI basis for PR19.

The cost of capital at Final Determination is as follows:

- **RPI-linked part of the RCV** – 1.92% for the wholesale business and 0.04% for the retail margin
- **CPIH-linked part of the RCV** – 2.92% for the wholesale business and 0.04% for the retail margin
- **Blended average** – The apportionment of the RCV between RPI and CPIH inflated bases results in a 'blended' real return of 2.52% for the wholesale business and 0.04% for the retail margin.

Adjusting from Ofwat's nominal returns<sup>1</sup> the Final Determination uses a rate of c.2% for CPIH and c.3% for RPI, assuming a c.100bp wedge between the two inflation rates. The implied blended inflation equates to c.2.4% and is applied across all wholesale price controls.

The tax rate assumed in the Final Determination remains at 17%<sup>2</sup> whilst notional gearing is also consistent at 60%.

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

Real returns based on:	K6 Final Determination 2015-20	K7 Final Determination 2020-25		
	RPI	RPI	CPIH	Blended average
Appointee vanilla cost of capital	3.85%	1.96%	2.96%	2.56%
Wholesale vanilla cost of capital	3.70%	1.92%	2.92%	2.52%
Residential retail margins	0.15%	0.04%	0.04%	0.04%
Equity return <sup>3</sup>	6.00%	3.28%	4.29%	3.90%
Cost of debt <sup>4</sup>	2.59%	1.15%	2.14%	1.74%
Cost of embedded debt	2.65%	1.43%	2.42%	2.02%
Cost of new debt	2.00%	-0.45%	0.53%	0.13%
Tax	20%	17%	17%	17%
Notional gearing	62.5%	60.0%	60.0%	60.0%

including 10bps fast-track award

<sup>1</sup> Based on the appointee allowed return on capital (vanilla) of 5.02%

<sup>2</sup> If headline rates for tax are different these will be trued up at PR24

<sup>3</sup> Additional 10bps reflects the effect of fast-track award

<sup>4</sup> The cost of new debt has been set based on the iBoxx A/BBB point estimate. Where the actual iBoxx rates differ over the regulatory period these will be trued up at PR24.



# Outcome Delivery Incentives

Our business plan targeted ambitious performance levels across all areas of our business, with the aim of being sector leading in the areas of service customers value the most.

Our industry leading customer research and engagement programme ensured that our performance commitments reflected the interest of our consumers – today and in the longer term.

The Final Determination performance levels are stretching. We remain confident, however, that at the heart of our plan our goal to deliver high quality, efficient and affordable services to our customers, focused on what matters most to them, meeting all our statutory obligations in the context of the unique natural environment on which we operate, remains. We are proud of our track record of delivery and our plans for 2020-25 build on this success.

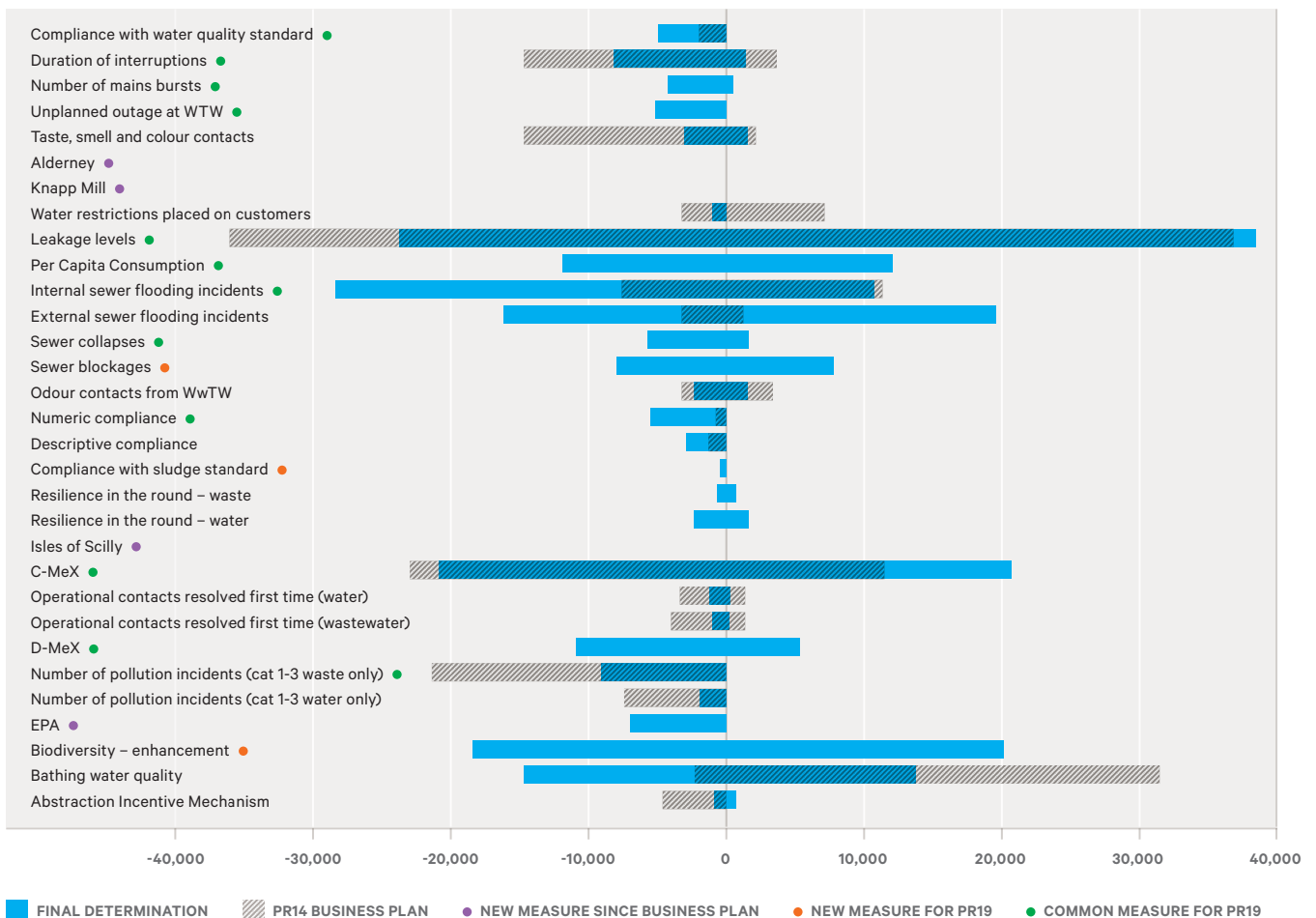
During 2015-20, South West Water has continually delivered against the plan agreed with our customers, making great strides in sustainable service and environmental improvements. Some of our highlights include:

- Our highest ever performance on the key industry measure of customer service (SIM)
- Meeting our leakage targets every year
- Achieving a 58% reduction in supply interruptions since 2014
- Delivering a significant reduction in internal and external sewer flooding.

## The overall incentive package

The Final Determination has resulted in an overall range of incentives from an outperformance payment of £159m (£120m PR14) to an underperformance payment of -£218m (-£183m PR14) including the potential impact of C-MeX and D-MeX. This equates to a maximum range on RORE of +2.2% per annum for outperformance payments to -2.6% per annum for underperformance payments.

## Annual ODI range (£k)



# Return on Regulated Equity (RORE)

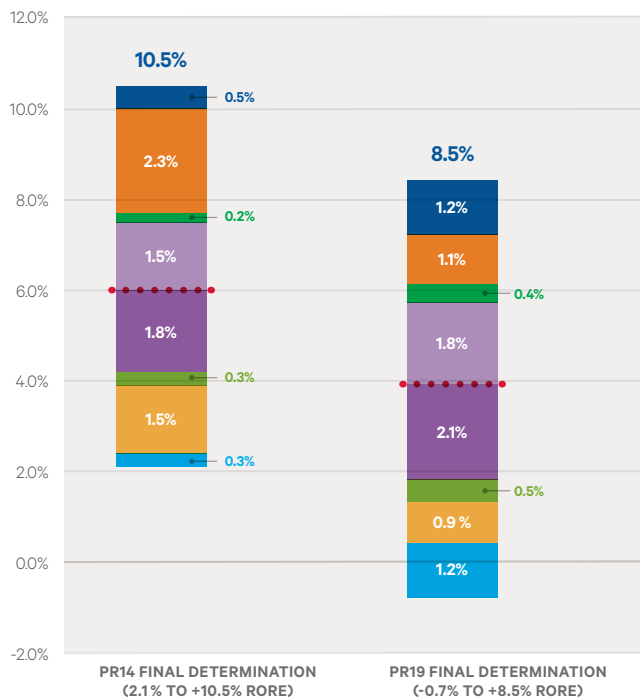
Ofwat's view of the overall Return on Regulated Equity range for the Final Determination for South West Water is -0.7% to +8.5%. For the Final Determination Ofwat reassessed all companies' RORE ranges and applied consistent assumptions across the industry for totex and financing with ODIs, C-MeX and D-MeX being company specific assessments.

Whilst this approach results in a consistent totex and financing position across the industry it does not necessarily reflect South West Water's potential outperformance.

The variance of c.200bps in the upper end of the RORE range between PR14 and PR19 (10.5% to 8.5%) is largely a result of the reduction in the industry base cost of capital allowance. The magnitude of the potential outperformance on RORE is broadly equivalent with PR14 at c.450bps.

Ofwat's view of the individual RORE components are described below:

## RORE



- 1 Financing risk for a notionally geared company at the Ofwat cost of debt is calculated at a range of -1.2% risk and +1.2% opportunity within the RORE range.
- 2 Totex impacts reflect Ofwat's reassessment of potential under and outperformance against an efficient cost base (-0.9% to +1.1%).
- 3 C-MeX / D-MeX underperformance penalties and outperformance payment ranges from -£6.3m to +£5.2m on average per annum. This equates to a RORE range of -0.5% to +0.4%.
- 4 ODIs provide for additional returns for improvements in service levels beyond our central plan and industry norms. Based on the P10/P90 scenarios, this amounts to a potential range of -£37.3m to +£26.6m per annum, giving a RORE range of -2.1% to +1.8%.

- 1 Financing reward
- 2 Totex savings
- 3 C-MeX/D-MeX outperformance payment
- 4 ODI outperformance payment
- Financing risk
- Totex overspend
- C-MeX/D-MeX underperformance penalty
- ODI underperformance penalty
- Cost of equity

## Our relationship with our customers will be transformed by sharing more of our success, and offering them a stake and a greater say in the business.

The key features in our plan which will enable this transformation are:

- South West Water is committed to sharing the accrued benefits with customers
- c.£20m of accrued benefits from the PR14 (2015-20) WaterShare mechanism due to customers will be offered in the form of Pennon shares, a reduction in their bill or a cash rebate
- All eligible customers will be able to choose a rebate or bill reduction, however only household customers meeting specific criteria will be able to receive Pennon shares
- Total value per eligible customer of c.£20
- No dilution of existing shareholdings or voting rights
- Eligible customers who choose to participate in the share scheme will receive a share of company profits, in the form of dividends, as and when shareholders do
- All customers will be invited to attend a new customer AGM, voting on the appointment of WaterShare+ panel members and attending quarterly public meetings.

WaterShare has been central to our engagement with South West Water customers since 2015. WaterShare has always given our customers reassurance about the transparency and openness of our business, with our performance being reported to customers through the WaterShare scorecard and framework, overseen by an independent WaterShare panel. This review and scrutiny of performance and engagement with customers has also been undertaken by the independent Customer View Group at Bournemouth Water.

For South West Water's 2020-25 business plan, we have reviewed the established WaterShare approach to ensure we continue to build on our relationship with our customers and look at how we can better embed our sharing of regulatory outperformance benefits. Our existing WaterShare mechanism allows for us to share gains as a result of changes in market assumptions for both the cost of new debt and taxation. We were pleased to see that Ofwat adopted this in the base methodology for PR19 (2020-25) for the benefit of all customers.

Our voluntary proposal for PR19 was for a mechanism consistent with our sharing principles of adjusting for market based assumptions that can be used to share net financing outperformance relating to debt raised in previous regulatory periods.

Using the regulatory assumption of a proportion of new debt raised over the previous regulatory periods (PR04 and PR09) could result in financing outperformance (on a similar scale to the value returned to our customers in the period to 2020) to 2025 as and when outperformance is recognised.



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