Elements of the plan

Aligning Risk & Return

a shared Water Future

South West Water

Bournemouth Water

Elements of the plan

an engaged WaterFuture — Engaging Customers

an affordable WaterFuture — Addressing Affordability & Vulnerability

an outcomes WaterFuture — Delivering Outcomes for Customers

a resilient WaterFuture — Securing Long-Term Resilience

an innovative WaterFuture — Targeted Controls, Markets & Innovation

an efficient WaterFuture — Securing Cost Efficiency

a shared WaterFuture — Aligning Risk & Return

a confident WaterFuture — Accounting for Past Delivery

an assured WaterFuture — Securing Trust, Confidence & Assurance

Contents

Introduction

This document summarises the work South West Water has undertaken to assess the financial balance of the business plan to 2025.

Key aspects that have been reviewed are;

- How uncertainty, risk identification and mitigation has been tested
- How financeability has been assessed and customer bill impacts considered
- How returns to providers of finance have been reflected, and the approach to fairly sharing any outperformance with customers.

For the period 2020-25, Ofwat has given greater clarity on its expectations for aligning risk and rewards through its recent publication 'Putting the sector back in balance: position statement on PR19 business plans'. There continues to be significant challenge to ensure that companies are open and transparent with their corporate structures and are clearly sharing benefits of outperformance with customers.

Business plan navigation

This document is part of the overall business plan providing key information about our proposals and how it answers the initial assessment of business plan tests.

Aligning Risk & Return

RR 1 Has the company based the separate costs of capital that underpin each of its wholesale price controls, and the net margin(s) that underpins its retail price control(s), on those we state in our early view? If not, to what extent has the company robustly justified, in terms of benefits for customers, its proposed costs of capital and retail margin(s) within the context of expected market conditions for 2020-25?

RR 2 To what extent has the company demonstrated a clear understanding and assessment of the potential risks in its RoRE assessment, including the effect of the risk management measures it will have in place, across each of the price controls?

RR 3 Has the Board provided a clear statement that its plan is financeable on both an actual and a notional basis? Is the statement appropriate and how robust is the supporting evidence?

RR 4 How appropriate are the company's PAYG and RCV run-off rates? How well evidenced are they, including that they are consistent with customers' expectations, both now and in the longer term?

Answers to these questions are summarised in the **Summary** chapter of this document, with signposts to further detail and evidence within this document, and where appropriate, other documents forming part of the overall business plan submission – see **Document map**.

Document map

The primary documents within the business plan submission are illustrated below. Other supplementary information, reports and documents are also referenced within these documents and can be accessed using a link in the document, where appropriate.

Business plan to 2025

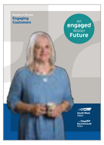

Business Plan

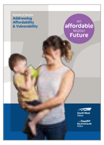

WaterFuture Customer Panel Report

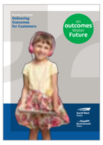

Customer Summary


Investor Summary

Elements of the plan


Engaging Customers


Addressing Affordability & Vulnerability


Delivering Outcomes for Customers


Securing Long-Term Resilience


Targeted Controls, Markets & Innovation


Securing Cost Efficiency


Aligning Risk & Return
(this document)

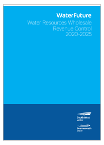

Accounting for Past Delivery

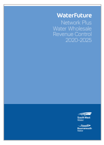

Securing Trust, Confidence & Assurance

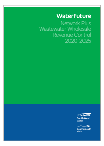

Board Assurance Statement

Revenue controls

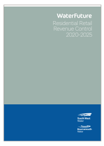

Appointee Summary
+ Tables and commentary


Water Resources Wholesale Revenue Control
+ Tables and commentary


Network Plus Water Wholesale Revenue Control
+ Tables and commentary


Network Plus Wastewater Wholesale Revenue Control
+ Tables and commentary

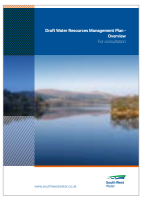

Bioresources Wholesale Revenue Control
+ Tables and commentary


Residential Retail Revenue Control
+ Tables and commentary

Business plan to 2050


2050 Vision


2050 Environment Plan


Draft Water Resources Management Plan

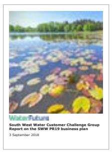

Drainage and Wastewater Management Plan

Executive summary

Our commitment is to provide a reliable service based on customers priorities whilst minimising the cost to deliver it.

To achieve that commitment we must ensure we have the ability, financially, to undertake the required investment, and operationally deliver the required services.

To attract and maintain efficient financial funding for that investment, we require a fair return for our investors whilst ensuring that customers bills are as low as they can be. Our dividend policy has clear and transparent principles and these are supported by the independent WaterFuture customer panel (WFCP).



For more information, see
WaterFuture Customer Panel report

Base dividends are made with reference to Ofwat's assessment of a notional balance sheet – using notional gearing assumptions. For the business plan to 2025, we have independently reviewed the assumptions in Ofwat's early view of the cost of capital and margin allowances. We believe Ofwat should consider both historical and forward looking assessments, and whilst our estimated range of the cost of equity is broader than Ofwat's, we have used Ofwat's draft assessment in our plan.

Outperformance dividends – are those linked to business performance and outcomes delivered ahead of the business plan – the principles of outperformance and how this is fairly shared between customers and shareholders has been tested through customer and stakeholder engagement and underpins our outperformance dividend calculation. For South West Water this is also tested and challenged by our independent WaterShare panel.

WaterShare

The policy is designed to ensure that the ability of the appointed business to finance its business is not impaired.

Whilst the business plan is outlined to 2025, due to the nature of our activities, much of our investment, and logically our funding, needs to be sustainable for the long term; in fact demonstrating our financial resilience is key.

For more information, see
Securing Long-Term Resilience

We have constructed a **base plan that is financeable on both a notional and actual basis**. We have tested the financial robustness of our plan through a number of scenarios and have mitigations that can address financeability pinch points which may arise.

We have tested this at both an appointee and an individual revenue control level.

For more information, see
Appointee Summary

Our balance sheet is conventional and robust and our financing approach, with a diversified portfolio of debt instruments and banking relationships, continues to support flexibility over the review period. Our financial reporting is transparent and our strategy in areas like taxation has been developed following specific customer consultation on their expectations.

We have also sought to ensure business priorities are reflected in our financing approach. We have developed and implemented a **sustainable financing framework**, one of the first of its kind in the UK.

All our debt financing requirements will be assessed under this framework which seeks to directly link South West Water's performance against environmental, social and governance factors with the cost of funding. So far, since implementing the framework, all our South West Water debt requirements have been raised in this way. Sustainable financing through green, impact and social loans is a developing market, and access to this market gives South West Water further options and flexibility.

We are pleased Ofwat's methodology continues to incentivise financial outperformance for the benefit of customers and investors, and we need to ensure we continue to get the balance right.

Our customer research indicates that customers also support the incentives approach, but incentives need to be fair and transparent, with risk appropriately apportioned and mitigated. We also know that transparent performance reporting and benefit sharing is key.

As a result we are extending our pioneering WaterShare approach through to 2025.

For more information, see
Engaging Customers

Our WaterShare approach started in 2014 and embodied a number of key principles:

- Independent scrutiny and review of our delivery and financial performance through a 'WaterShare' panel
- Transparent reporting of performance
- Sharing of net outperformance over and above regulatory mechanisms on a timely basis
- Return of 'unearned' gains where assumptions made for a business plan turn out to be different (for example changes in the industry assumed cost of new debt relative to market movements and changes in taxation rates).

We pioneered this approach to benefit sharing and are now voluntarily proposing to adopt an approach which further extends sharing of net gains over and above the regulatory methodology as and when they arise.

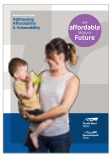
In particular we have reviewed the approach to assessing embedded debt costs and are proposing to extend our 2015-2020 cost of new debt sharing proposal.

We are proposing to share with customers any net benefit arising from the market movements for previous regulatory period new debt assumptions. Having tested the cost of new debt mechanism in this delivery period, we believe this approach could be applied retrospectively. As this relates only to market movements, this still preserves the ongoing incentive for outperformance by management action.

There is a real opportunity, using the flexibility afforded by Ofwat's regulatory model for this business plan, to ensure we continue to get the balance right between customers and investors. Indeed our business plan will lead to empowered customers who will be able to hold the business to account for its financial performance through our extension of our WaterShare approach and the ability for customers to have a real 'stake' and a say in the business, with aligned objectives for investors and customers.

In summary we believe we have a plan that demonstrates that we:

- Have considered risks and how these could be mitigated over the plan period
- Understand the importance of incentives that drive benefits and how those benefits can be shared appropriately between customers and investors
- Have a robust and financeable plan
- Are committed to transparency and scrutiny, through our supported dividend, financing, taxation and Executive pay policies.
- Have assessed the alignment of risk and return in detail, considering the following areas:
  - Managing risk and uncertainty
  - Financial resilience and sustainability
  - Appropriate returns and sharing outperformance
  - Balancing affordability and financeability.



For more information, see
Addressing Affordability & Vulnerability

Key messages

- **A tested financial plan, with outlined mitigations for risks as they may arise with detailed scenario analysis and risk assessment of all aspects of RoRE across the value chain**
- **A robust conventional balance sheet**
- **Diverse and flexible financing – aligned with business priorities and delivery against environmental, social and governance factors giving access to future funding opportunities**
- **Extension of WaterShare principles. Voluntary embedded debt sharing mechanism proposed (cost of new debt sharing mechanism already embedded into PR19 final methodology)**
- **Recognition of costs through PAYG ratios and RCV run off rates that are aligned with customer expectations**
- **Customer supported bill profiles which result in reduced bills over the plan period in real terms, and bills on a nominal basis lower at the end of the period than they were 15 years ago**
- **Transparent and consistent financial policies and approach:**
  • Dividends and executive remuneration– linked to performance and delivery
  • Tax – robust, transparent and low risk

Managing risk and uncertainty – supporting financial resilience

The approach to risk identification and management is key to assessing the balance of the business plan to 2025 and ensuring we have identified strong mitigations for risks that may manifest over that period.

South West Water faces a variety of risks which, should they arise, could materially impact its ability to achieve its strategic objectives. Successful management of these existing and emerging risks is essential to the long-term success of the company.

South West Water has a mature Group-wide integrated risk management framework which is fully embedded into our governance structures and embodies two of our values of 'trusted' and 'responsible' in the way we carry out our business.

Our risk management approach incorporates both 'top down' and 'bottom up' processes, ensuring a common understanding of the risks and opportunities that the company is exposed to and how they may impact upon the achievement of our strategic priorities.

A consistent methodology is applied to the identification, evaluation and management of the company's principal risks which considers both the likelihood of the risk occurring and the potential impact from a customer and other stakeholder, financial, management effort and reputational perspective.

Principal and business risks are captured within the company's Risk Register. This register includes a description of the risk, the related legislation and obligations, mitigations and controls which are in place, assessments of the scale of the risk before (gross risk) and after (net risk) mitigations and controls in place as well as an assessment of the company's appetite for the risk as well as the direction of travel of the risk level.

Quarterly risk and assurance forums are held to review both principal and business risks with management justifying their risk assessments through formal reports and presentations. These forums consider risks on a cyclical basis, as well as when there are significant events or circumstances which have resulted in a risk significantly changing.

The UK Corporate Governance Code requires companies to determine their risk appetite with respect to the level of risk it is considered appropriate to accept in achieving their strategic objectives. Striking an appropriate balance between risk and reward is key to the success of the company's strategy. The Board has established its risk appetite for each of the principal risks which allows the business to pursue value enhancing opportunities, whilst maintaining an overall level of risk exposure which the Board considers to be appropriate.

Horizon scanning is undertaken to assess the future environment and potential impact on the business.

South West Water seeks to reduce and mitigate its risk exposure, in line with the desired risk appetite and tolerance levels, through the operation of a robust internal control environment.

The process by which executive management and the Board receive assurance that mitigating controls are operating effectively, to reduce the risk exposure in line with the desired risk appetite and tolerance levels, is aligned to the "three lines of defence model":

- **First Line:** Management performance reviews, local quality control processes, sense checking and annual certification and sign off of submitted data
- **Second Line**: Policy setting and compliance checking, business management systems, internal audits, quality assurance and ISO reviews, risk and compliance internal reviews
- **Third Line:** Pennon Group independent internal audit, external financial audit, technical audits, external quality management system audits and other assurance providers.

This risk based approach to assurance is applied to all areas of the business, including key projects at all levels. The mix of assurance methods used is reviewed by the South West Water Audit Committee, which is responsible for ensuring robust and comprehensive assurance frameworks are in place to support Board assurance and compliance requirements.

Principal risks and uncertainties

South West Water's business is exposed to a variety of external and internal risks. The assessment of the company's principal risks is informed by the potential impact of macro level political, economic and environmental factors. Whilst the ability of the company to influence these macro level risks is limited, they continue to be regularly monitored and the potential implications for the company are considered as part of the on-going risk assessment process. This includes undertaking scenario planning and analysis to understand the potential risk exposure of one, or a number, of these events occurring and taking appropriate steps to reduce the impact on the company.

South West Water maintains a strong liquidity and funding position with consistent levels of cash deposits supplemented with a pipeline of undrawn facilities to manage future funding requirements. Our financing structure gives the scope and flexibility needed to implement our strategic objectives and maximise value.

Funding facilities are in place to cover both medium and long-term requirements, including loans from the European Investment Bank (EIB) and finance leasing arrangements. In addition, short-term facilities exist with a range of financial institutions.

Financial viability of the plan

The Board has assessed the financial viability of the business with reference to the plan presented, and has a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due over the plan period to 2025.

The assessment has been made with reference to the business plan forecasts presented, the business risks identified and how these are mitigated.

In stress testing the business plan we have considered the principal risks assessment and whether individual risks in isolation or in aggregate could impact on the financial viability of the business.

We have also considered the following scenarios

- **South West Water viability assessment** – reference to South West Water's own identified risk register
- **Scenario testing** – scenarios which consider a range of probabilities (P10 / P90) with the detailed outputs reported in Business Plan table App 26 and based on RoRE performance expectations
- **Ofwat's Financial Resilience tests** – stress tests which are considered to assess the financial resilience in line with Ofwat's recent guidance.

We have undertaken the following steps in assessing the level of our risk:

- Provided a review of our principal risks which are linked to our long-term financial resilience statement
- Undertaken the risk modelling producing a P10 / P90 RoRE range (presented as part of the Table – App26)
- Provided a detailed explanation of the modelling approach and the assumptions / analysis underpinning the quantum of the RoRE impacts
- Used historical data and business judgement to inform our assumptions as appropriate
- Have provided an explanation of the potential mitigation actions / preventive measures that we would put in place under the relevant scenarios and their potential effect.

South West Water viability assessment

We have assessed how risks may manifest in the business period to 2025, with reference to changes in the principal risk assessment we may see over that period.

Our approach to assessing these risks considers both the impact of the risk and likelihood of the risk occurring. These are then monetised and the impact on the financial performance is considered. A key factor considered for long-term viability is the 'headroom' available to South West Water in relation to its debt covenants.

Given the very strong funding position of South West Water and the long-term nature of our business model, the primary impact of stress test scenarios are considered against both South West Water's ability to raise additional funds and meet its covenant obligations.

South West Water's financial forecasts are produced as part of a rigorous business planning process which uses all available information about the future and has, as an important and integral part of the process, a comprehensive assessment of business risks.

For the purposes of the viability test, sensitivity analysis on the base financial case has been performed. The sensitivity analysis has been linked back to the reported principal risks and likelihood of occurrence.

The financial impacts for the risk sensitivity are based on an assessment of the potential financial impact and likelihood of the risk occurring. These are then combined to make an annual assessment and the impact over five years. The financial impact is based on a number of factors including historical impacts (such as the atypical costs incurred for extreme weather events), external evidence or market information and likelihood of the risk arising – with a number having a < 10% chance of arising after mitigations in place.

Scenario testing

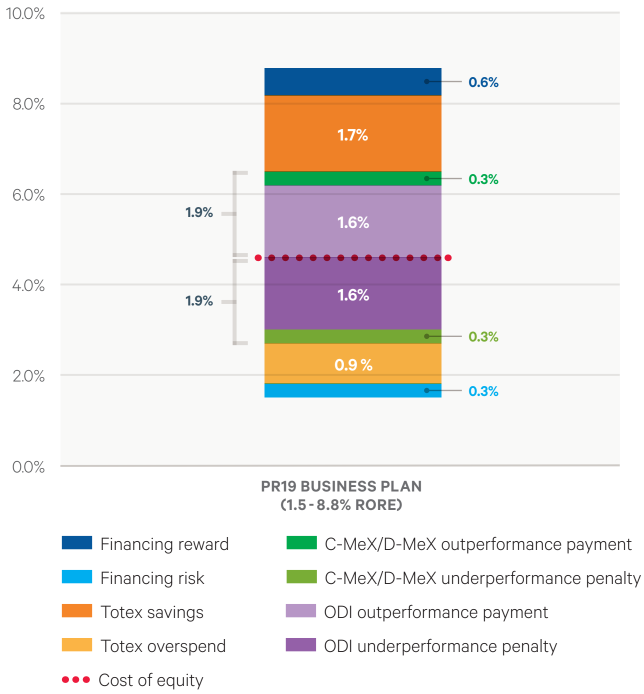
South West Water has assessed a number of scenarios which consider a range of probabilities (P10/P90) based on RoRE performance expectations, and the financial impacts of these. In line with Ofwat's methodology the detailed outputs and detailed commentary on our approach are reported in the business plan table App 26 – Scenarios. The elements tested in the scenarios were:

- **Revenue** – considered the impact of new customers and increases in other revenues
- **Totex** – cost scenarios have considered the impact of cost pressures, efficiency delivery, risk surrounding specific items such as rates, power and capital delivery
- **Residential retail costs** – reflects the potential impact of changes in bad debt costs and input price pressures within the retail revenue control
- **ODI performance** – detailed modelling has assessed the upside and downside risks for ODI performance, with the range of performance broadly stable across rewards and penalties
- **C-MeX and D-MeX** – the detail of these new customer service metrics are still under development with pilot assessments only recently made. Whilst the impact of these items is uncertain we have assessed the potential impact of under/outperformance for these scenarios
- **Financing** – this scenario considers the potential impact on the total finance costs as a result of movement in the market interest rates (through the iBoxx) and changes in RPI.

These specific scenarios have been assessed on a notional structure (aligned with Ofwat's approach for assessing returns) and have resulted in an average RoRE range over the period of 1.5% - 8.8%. The chart below outlines the individual elements of performance.

Base returns for 2020-25 are 4.6% (being the blended average cost of equity) and based on the scenarios there is potential for a doubling of returns for outperformance. The RoRE range is largely consistent with 2015-20, albeit from a lower base.

RoRE



The individual RoRE components are described below.

Financing risk for a notionally geared company at the Ofwat cost of debt is estimated at a range of -0.3% risk and +0.6% opportunity within the RoRE range.

Totex impacts consider both individual cost risks and opportunities and reflects our experience of delivery in this area.

C-MeX / D-MeX underperformance penalties and outperformance payment ranges from a +/- £4m on average per annum. This equates to a RoRE range of -0.3% to +0.3%.

ODIs provide for additional returns for improvements in service levels beyond our central plan and industry norms. Based on our P10/P90 scenarios, this amounts to a potential +/- £21m per annum, giving a RoRE range of -1.6% to +1.6%.

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

Ofwat's financial resilience tests

In assessing the financial resilience of the business we have considered the specific sensitivities outlined by Ofwat. This has included a mix of one-off impacts as well as those which occur over the period.

Ongoing impacts:

- Totex underperformance (10% of totex) in each year
- Inflation high and low scenarios of +/- 1
- Increase in the level of bad debt costs of 5%
- Debt refinanced as it matures at 2% above forward projections.

One-off impacts:

- ODI penalty of 3% of RoRE
- Financial penalty equivalent to 3% of Appointee revenue.

We also considered a specific combined scenario which included:

- Totex (including retail) underperformance of 10% in each year
- ODI penalty of 1.5% of RoRE in each year
- Financial penalty equivalent to 1% on Appointee revenue for one year.

South West Water does not have any intercompany financing arrangements outside of those directly with its wholly owned subsidiary South West Water Finance Plc. The two bonds raised are back-to-back as if they were held directly. There are no group financing arrangements except for £100m facility available from Pennon which can be drawn on a short-term basis. Therefore we have not included any intercompany financing scenarios.

Gearing

Ofwat has assumed notional gearing at 60% for 2020-25 and set a maximum of 70% above which further sharing of outperformance with customers is expected. Each of the scenarios is within the range for investment grade credit ratings of 55-70%.

South West Water's based actual interest cover has been presented excluding the pension deficit payment in the first two years of the period as this reflects the approach taken for credit rating agency assessments. The notional basis is presented before legacy adjustments which were also profiled in the first two years.

The scenarios have been calculated based on the Ofwat model and therefore all lower in the first two years by c. 0.2. As anticipated the combined scenario is below the minimum threshold.

Whilst below the minimum level for this metric the combined scenario is deemed to be remote as they do not take account of mitigations which the company would implement over the period (for example continued totex underperformance would not be accepted and additional efficiency plans would be targeted to mitigate cost risks).

All other scenarios are on average above the 1.2x and excluding the pension contributions only improves these positions.

FFO / net debt ratio approaches differ between rating agencies as noted in the range above.

FFO is also impacted by the pension contributions in years 1 and 2 as these payments are included within operating cashflows. FFO increases by c. 0.01 if the pension is excluded and would move a number of these above the high range.

If faced with a challenge around this metric through unexpected cost pressures or one-off issues South West Water would have the option of mitigating net debt increases by deferring dividend payments into subsequent years.

From the assessments undertaken above, whilst the scenarios which have a significant one-off impact may challenge the financial ratios in one individual year, these are deemed to be remote in terms of likelihood and therefore do not challenge the overall viability or long-term financial resilience of South West Water.

A number of the scenarios do not take account of mitigations which the company would implement if such scenarios arose (for example continued totex underperformance would not be accepted and additional efficiency plans would be targeted to mitigate cost risks). This further strengthens the expectations of financial resilience over the period.

In addition, in extreme circumstances South West Water would be able to defer dividend payments to support its long-term viability if required.

Given South West Water's business plan on both an actual and notional basis is financeable and only in extreme circumstances would the key financial metrics be breached, we believe our plan shows a strong financial resilience to potential downside impacts and there would be a number of potential mitigations and management interventions which would be able to mitigate any viability risks.

Supporting financial resilience

Financeability & financial resilience

Financeability for South West Water is the ability of the business to raise capital on reasonable terms to finance new investment and refinance existing assets.

We believe that our business plan based on a notional basis is financeable and key ratios improve when considered against the actual structure.

We have tested the parameters identified by Ofwat in its final methodology (WACC and cost of equity). We have derived the dividend cover from our assumed dividend yield of 4.0% and a growth rate of 1.03%. In terms of the credit metrics, we have used the published thresholds targeted by the credit rating agencies where they were available. We have also tested against our tightest covenant levels for the debt instruments we have in place.

We would expect South West Water to be able to meet a 'shadow' investment grade credit rating over the 2020-25 regulatory period.

The projections indicate that there is headroom over the 2020-25 regulatory period and that as a result of the mitigations outlined, we believe the plan is financeable.

'Fast' and 'slow' money

At PR14 the regulatory framework transitioned from an operating and capital costs and current cost accounting approach to a new totex approach to setting prices as costs are recovered where pay-as-you-go (PAYG) and run-off rates were utilised to reflect the revenues recovered through customer bills.

At PR14 and for this business plan to 2025, we have recognised in revenues the costs as they would naturally fall. This approach is aligned to the views of our customers and is based on their feedback against consequential bill profiles presented.

The run off rates recover a value equivalent to the current cost depreciation which would have been expected.

RCV run-off rates have been calculated based on the following:

- Comparison of existing asset registers – both MEAV and historical cost
- Condition and performance of the asset base and the maintenance and replacement programmes we are proposing
- A test over the long term of the equivalence of the maintenance / replacement programme and RCV run-off.

For RCV run-off we assumed that the rates for assets at 31 March 2020 would be consistent whether under RPI or CPIH inflation and would be constant throughout the 5 years. The rate for additions post 2020 is based on the nature of the planned capital programme.

The approach to RCV run-off differs between the network plus business units and the new water resources and bioresources revenue controls.

The larger network plus RCV run-off is calculated based on a rate for RPI linked RCV (equivalent to 50% at March 2020) and a combined rates for 50% CPIH linked opening RCV and new additions over the 2020-25 business plan.

The run-off rate for the CPIH linked RCV is the weighted average of the existing RCV and the estimated asset lives of new additions and therefore varies over the period as the weighting changes.

	RPI RCV %	CPIH RCV %
Water network +	4.7	4.7-4.6
Wastewater network +	5.2	5.1-5.0

The run-off rates for the network plus revenue controls are similar as they both contain a mix of infrastructure (in water distribution and sewerage collection) and non-infrastructure assets for treatment works.

For the new revenue controls RCV is separated between opening RCV linked to RPI, CPIH and CPIH additions. It is assumed that the run-off rates for existing opening RCV is consistent whether increased by RPI or CPIH. Additions are based on the estimated average asset lives linked to capital programme and remain constant throughout 2020-25.

	Opening RCV %	RCV additions %
Water resources	2.5	4.6
Bioresources	9.2	4.6

The run-off rates for water resources opening RCV are lowest across all the revenue controls as this reflects the large proportion of infrastructure assets. Additions to water resources during 2020-25 are focused on non-infrastructure assets and therefore have shorter asset lives.

For bioresources the majority of assets are non-infrastructure and therefore have shorter asset lives. Non-infrastructure additions are the focus for 2020-25 and therefore the asset lives are similar to water resources.

The weighted average RCV run-off for water of 4.5% and wastewater 5.2% are marginally higher than PR14 (3.9% and 4.9% respectively) due to the nature of the assets, particularly actual non-infrastructure additions, having shorter lives.

The table below shows the natural PAYG rates that reflect our actual operating cost and operating expenditure like items on annual basis. The PAYG has been derived from the operating expenditure plus the proportion of capital maintenance spend historically recognised under Infrastructure Renewals Expenditure (IRE). It excludes any pension deficit payments allowed.

PAYG ratios	2020 / 21 %	2021 / 22 %	2022 / 23 %	2023 / 24 %	2024 / 25 %
Water resources	74.7%	68.9%	74.5%	78.0%	78.6%
Water network+	64.5%	59.7%	53.5%	54.6%	56.0%
Wholesale water	65.5%	60.6%	55.3%	56.5%	57.9%
Wastewater network+	50.9%	52.2%	55.4%	55.8%	58.7%
Bioresources	73.0%	72.3%	69.9%	71.1%	73.2%
Wholesale wastewater	53.0%	54.2%	57.0%	57.5%	60.4%
Total Appointee	**58.5%**	**57.2%**	**56.1%**	**57.0%**	**59.1%**

To ensure the bill profiles are acceptable to customers the revenue legacy adjustments for past performance have been used to ensure a smoother profile – rather than adjusting the underlying PAYG or RCV run-off rates.

The final bill profiles are outlined in the 'balancing affordability and financeability' section of this document.

Financeability means the ability of the business to raise capital on reasonable terms to finance new investment and refinance existing assets.

We consider that there are two components to financeability:

- An expected return on RCV that appropriately remunerates the cost of capital
- Financial metrics which are in line with either an investment grade credit rating (for companies that have a credit rating), or debt covenants (for companies that do not have a credit rating).

We have conducted the financeability tests on both a notional and actual bases, as required by Ofwat. The results of our assessment are discussed opposite.

Financeability on the notional basis

A notional company is the company that performs based on regulatory expectations and has the following features:

- It achieves the efficient totex determined by Ofwat
- It does not incur any penalties from ODIs / C-Mex / D-Mex
- Its returns are equivalent to the allowed cost of capital
- Its gearing is in line with the notional gearing assumption.

We believe that our business plan based on the notional structure is financeable and key ratios are largely consistent when considered against the actual structure.

Target credit rating for the notional company

South West Water is not required to have a credit rating as part of its licence. However, on an annual basis the Board is required to confirm that in its opinion the company would be able to meet an investment grade credit rating. This assessment was recently confirmed for the 2017 / 18 Annual Performance Report, based on external independent advice.

We consider that Ofwat's cost of debt allowance serves as the relevant reference point for determining the target credit rating. As Ofwat uses A / BBB+ indices to determine the cost of debt (both existing and new), it is appropriate to target the credit rating within that boundary.

The credit rating assessment considers a range of factors when considering investment grade, including financial ratios. South West Water is and would be expected to be assessed as investment grade based on these factors:

- **Asset ownership model** – the majority of South West Water assets are held outright or are on lease arrangements where options are in place to retain ownership of the assets after the lease term and remain within our control throughout
- **Scale and complexity of capital programme & asset condition risk** – the capital programme over the period is largely consistent with prior regulatory periods
- **Financial Policy** – South West Water's gearing has been below the notional level for 2015-20 and is largely aligned with the notional gearing set for PR19.

The key ratios for assessing the credit rating are

- Adjusted interest cover ratio (AICR)
- Gearing
- FFO / Net debt
- RCF / Net debt.

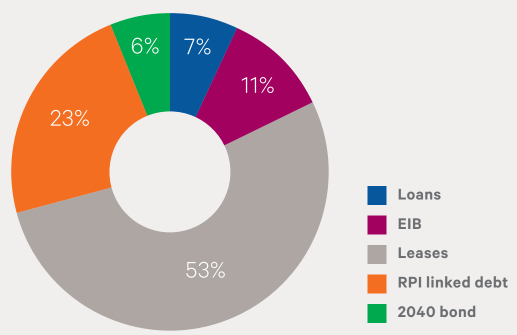
We have considered these metrics and would expect South West Water to be able to meet an investment grade credit rating over the 2020-25 regulatory period.

On a notional basis the key ratios used for a credit rating assessment are sufficient to meet an investment grade credit rating in each year.

The notional gearing of 60% is well within the level for the debt covenants and EBITDA interest cover for both pre and post legacy adjustments (as outlined below) are significantly above the minimum covenant level with considerable headroom available.

Financeability on the actual basis

South West Water maintains a strong liquidity and funding position with consistent levels of cash deposits supplemented with a pipieline of undrawn facilities to manage future funding requirements. Our financing structure gives the scope and flexibility needed to implement our strategic objectives and maximise value. Funding facilities are in place to cover both medium and long-term requirements, including loans from the European Investment Bank (EIB) and finance leasing arrangements. In addition, short-term facilities exist with a range of financial institutions.



South West Water's debt has a maturity is up to 40 years with a weighted average maturity at 31 March 2018 of c. 23 years. The longest instruments are our Index-linked bond and the 2040 Bond. These are issued by our wholly owned subsidiary South West Water Finance plc and balances and charges are back-to-back to ensure there is no impact to the regulated business.

To deliver an efficient cost of debt the majority of our debt is initially floating, which is then fixed either directly or through swaps to fix the interest rate. We aim to have at least 50% of debt fixed for a regulatory period. In addition South West Water has c. £530m of debt index-linked to 2041-2057 at an overall real rate of less than 2%.

The actual structure for South West Water reflects our gearing position (including opening RCV adjustments) and revenue legacy adjustments. The ratios have been calculated consistently with the notional structure.

Whilst the key ratios on an actual basis are lower than for the notional basis (with the actual structure reflecting higher gearing) the key ratios used for a credit rating assessment are sufficient to meet an investment grade credit rating in each year.

As part of the transition to a new Licence following the merger with Bournemouth Water, shadow credit metrics are reviewed by South West Water. Whilst South West Water does not have an investment grade credit rating, South West Water targets specific covenant ratios to enable it to raise the debt in the most efficient way.

We continue to believe that this approach is in the best interests of our customers. As well as mitigating the cost of obtaining and maintaining a credit rating, we have demonstrated that the diversified portfolio of debt instruments has enabled access to funding at efficient effective rates.

South West Water is expected to have surplus cash and facilities, excluding restricted funds, of on average c. £60m over the plan period assuming additional or renewed borrowing in that period is raised as required.

South West Water seeks to avoid maturity concentrations in its financing instruments, with the aim of having no more than 20% of debt maturing in any one year.

We will continue to target a mix of funding instruments and seek to maintain the efficient interest rates historically achieved. As part of the Pennon Group we will benefit from the Sustainable Financing Framework put in place during 2018.

The funding streams are shown to be accessible at effective rates.

This efficient funding has enabled South West Water to commit to sharing outperformance with customers during 2015-2020.

We have considered company analysis assuming that we will be continuing our operations without a credit rating and maintain the covenants relevant to our contractual obligations.

Aligned with Ofwat's methodology, we have assessed financeability both before and after PR14 adjustments.

We have also tested our flexibility on covenants as part of our scenario analysis.

Financeability on the individual revenue control basis

We have also considered the financeability of each revenue control to assess the key ratios and headroom in each of the wholesale controls. This was based on our actual company structure.

Whilst long-term financial resilience and viability are considered in aggregate at the Appointee level, the analysis highlights that the plan is financeable across all of the individual revenue controls.

Key messages

- Separate costs of capital and retail margins aligned to Ofwat PR19 final methodology and are broadly supported by evidence from independent third party reports
- External evidence to support investment grade credit rating
- Detailed scenario analysis and risk assessment of all aspects of RoRE across the value chain
- Appropriate PAYG and RCV run-off rates
- Customer testing and support for bill profiles over the short and long term resulting from PAYG and RCV run-off rates

Appropriate returns

We have reviewed and considered with the help of third party analysis, Ofwat's guidance for the cost of capital.

There are a number of areas we have tested, but we believe Ofwat's position is broadly aligned with our position.

As such we have prepared the business plan on the basis of the cost of capital and retail net margins in the PR19 Final Methodology document. For the cost of capital we have used the following figures:

- **RPI-linked part of the RCV** – 2.4% (RPI-real) for the appointed business and 2.3% for the wholesale business (deducting 10bp for the retail margin);
- **CPIH-linked part of the RCV** – 3.4% (CPIH-real) for the appointed business and 3.3% for the wholesale business (deducting 10bp for the retail margin).

We have used a 2% CPIH and 3% RPI, assuming a 100bp difference between the two inflation rates, consistent with the position in the PR19 methodology. We have adopted the same cost of capital across all wholesale price controls.

For the retail EBIT margins we have used 1% (non-contestable retail activities) which was consistent with our view at PR14 and we do not believe that there are changes in the risk profile which would suggest a change in the retail margin.

Whilst South West Water has applied the cost of capital set out in the PR19 methodology, we have separately reviewed and considered the potential range for the cost of equity and cost of debt and received external advice on the approach and overall cost of capital position.

Our approach to the cost of equity

We have commissioned a third-party report (Frontier Economics) to provide us with an independent assessment of the cost of capital and in particular the cost of equity.

South West Water's cost of equity was estimated using both the historical capital asset pricing model (CAPM) and the forward looking dividend growth model (DGM). The estimated range for the cost of equity from the two approaches is 4.2% to 7.0% in real RPI terms. The lower end of the range compares to Ofwat's cost of equity range of 3.4%-4.7% but we note it is higher than Ofwat's selected point estimate of 4.0%.

Our approach to the cost of debt

We have accepted Ofwat's approach to the cost of both embedded and new debt. We are pleased to see that our industry-leading approach to sharing of financing outperformance on debt has translated into an wide-industry approach.

Our voluntary proposal for PR19 is that a mechanism consistent with our sharing principles can be used to share net financing outperformance relating to embedded debt raised in previous regulatory periods.

Balancing affordability and financeability

Ofwat's recent publication 'Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans' requires company's Board to provide assurance that the business plan will enable customers' trust and confidence, through appropriate measures to provide a fair balance between customers and investors (which include outperformance sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement, on issues that matter to customers.

A key aspect in balancing the plan is the impact on customer bills. The profile of bills for customers is as follows;

Outturn prices	2019 / 20 £m	2020 / 21 £m	2021 / 22 £m	2022 / 23 £m	2023 / 24 £m	2024 / 25 £m	Average £m
South West Water	550	536	540	539	540	539	539
Bournemouth Water	145	142	144	145	145	145	144

Overall customer bills are remaining stable over the 2020-25 regulatory period on a nominal basis assuming inflation at CPIH of 2%. As a result of ongoing efficiencies and the performance from 2015-20 real bills are falling over the period.

With an average nominal bill of £539 over the period research shows 79% of customers find this acceptable. In the Bournemouth region an average bill of £145 is 80% acceptable.

We also know from customer consultation that it is important we have supported transparent financial policies in place. We believe we have the following sustainable financing approaches and policies in place.

Throughout our research customers have emphasised that they prefer stable bills and to 2025 we have sought to deliver this by managing legacy adjustments over the first two years. Whilst detailed modelling has been completed up to 2025 only, we have considered the position post 2025 and our view would be that over the 2025-30 period:

- Capital investment would be similar with a continued focus on maintaining outcomes and service but still with a quality programme (including completion of the Alderney water treatment works)
- PAYG rates and RCV run-off would continue to reflect the natural profile to ensure the appropriate balance of current and future prices
- Customer bills would be smoothed to manage increases appropriately.

Sustainable Financing Policies

Sustainable financing framework

South West Water has adopted the Pennon Sustainable Financing Framework, in alignment with ICMA Green Bond principles, Social Bond principles and the LMA green Loan principles. The framework has been independently verified by DNV GL.

The framework supports the financing of our water, waste water and retail activities that demonstrate our environmentally and socially sustainable outcomes. South West Water intends to raise finance to support sustainable investment in our operations.

South West Water will follow the green bond, social bond and impact loan principles to issue debt to meet funding requirements. The framework is aimed at providing the ability for South West Water to issue sustainable finance.

Since launching in May 2018, £110m of financing has been raised through the framework, and we anticipate the majority of the finance to be raised (either new or refinanced) will be issued in this way.

The cost of financing is intrinsically linked to the outcomes performance in the business.

Details of performance in the form of 'impact reporting' will be reported annually, to all stakeholders including the providers of finance.

Defined Benefit Pension Scheme sustainability

Over time we have developed pension provisions within South West Water that ensures benefits to employees are appropriate relative to the sector we operate in, and that the ongoing risks of rising liabilities are appropriately mitigated.

The scheme has been developed and we currently have an ongoing provision that economically is closely aligned with our defined contribution offering.

We are on track with a deficit recovery plan that was put in place following the 2016 actuarial valuation, and contributions have been agreed with the Trustees to 2022.

We regularly review the Employer's covenant with the Trustees and the Board has committed to the deficit recovery plan in place.

Dividend policy

South West Water has a well established dividend policy which involves the following components:

- **Base dividends** are derived from the price determination and **are made with reference to Ofwat's assessment of a notional balance sheet – using notional gearing assumptions**
- **Outperformance dividends** – linked to business performance and outcomes delivered ahead of business plan.

	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m	2021-22 £m	2022-23 £m	2023-24 £m	2024-25 £m
Base dividends	55.2	57.8	60.6	55.0	56.7	58.4	60.2	62.1
Notional[(1)] dividend yield	4.3%	4.4%	4.5%	4.1%	4.1%	4.1%	4.1%	4.2%
Actual dividend yield	4.1%	4.1%	4.1%	4.4%	4.4%	4.4%	4.3%	4.3%

(1) Notional for 2017-2020 based on 62.5% gearing.

Dividend payments are designed to ensure that key financial ratios are not prejudiced, whilst also taking into account balance sheet considerations. Payments are also designed to ensure that the ability of the appointed business to finance its activities is not impaired.

This dividend policy has been assessed and is supported by our independent WaterShare panel.

Actual dividends are calculated with reference to the projection with the Final Determination and outperformance dividends are directly linked to the delivery of the 2015-20 plan through the return on regulated equity (RoRE). Outperformance dividends are paid in arrears to ensure only actual and not forecast outperformance is paid.

During 2015-20 special dividends have been paid to ensure that South West Water's gearing remains aligned with Ofwat's notional level of 62.5% for 2015-20.

In line with Ofwat's proposals for the cost of capital, our plan assumes a 4.0% dividend yield with a real growth rate of 1.03% under the notional capital structures (this compares to 4% yield and 1.65% growth at FD14).

This approach ensures that the base dividend yield on both the actual and notional basis remains below 5% set by Ofwat. With South West Water's level of gearing being higher for 2020-25 (reflecting the lower RCV base) actual dividend yield is slightly higher than the notional, the opposite position from 2015-20.

The outturn dividend yield would however depend on the following:

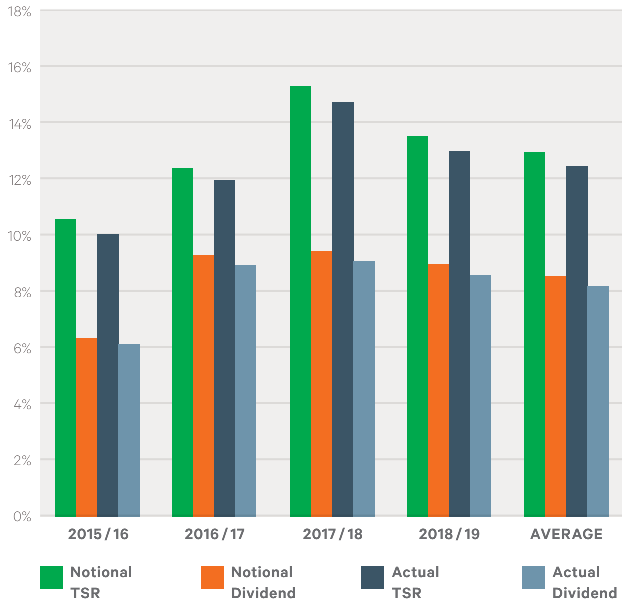
- Whether the company has delivered on its commitments to customers
- The level of out and underperformance against the regulatory allowances including ODIs, totex and financing
- Whether obligations to pension schemes have been met
- The level of financial resilience to ensure the long term viability of the appointed business.

Based on the factors already considered within South West Water's dividend policy we are confident that this already aligns with Ofwat's requirements and are therefore not proposing to change our dividend policy in 2020-25.

2015-20 dividends

Throughout the regulatory period South West Water has ensured that dividend payments are aligned with the returns due to investors / shareholders. The financial flows reported for the first time in 2017 / 18 reflects that dividends have been paid only reflecting the base allowances and the outperformance delivered. The chart below outlines dividends paid against both the notional and actual regulatory equity levels in the first three years and the forecast for 2018/19.

As a result of significant outperformance during the 2015-20 regulatory period the Total Shareholder Returns (TSR) are ahead of the average expected base of 7.8% and therefore dividends are also ahead of the 4.0% assumed in Ofwat's determination.



Taxation strategy

Paying tax is one of the many ways South West Water contributes to the community. We work hard to be efficient and effective in order to deliver the best possible result for customers and communities.

With regards to tax we make sure we follow the letter and the spirit of the law. This means filing our returns on time and making all tax payments by the due date, and also considering how tax fits into our business decisions.

We have a robust and transparent tax strategy. We

- At all times consider South West Water's corporate and social responsibilities in relation to its tax affairs
- Operate appropriate tax risk governance processes to ensure that the policies are applied throughout the company
- Comply with our legal requirements
- Do not enter into artificial tax arrangements or take an aggressive stance in the interpretation of tax legislation
- Do not undertake transactions that are outside of South West Water's low risk appetite for tax
- Engage with HMRC in a proactive and transparent way.

To assist in the development of our tax strategy we undertook customer and stakeholder research. The majority of customers surveyed thought that the company's attitude to tax planning was acceptable.

95% had a positive or neutral view of our tax strategy.

Remuneration policy

Executive Director remuneration is linked to both the company's operational and financial performance via the performance related bonus arrangements. A significant proportion of the Executive Directors' remuneration is provided as variable pay that rewards the achievement of stretching annual and long-term performance targets, which in turn are designed to ensure delivery of the company and Group's strategy and create shareholder value.

South West Water discloses annually the performance of Executive Director's within the Annual Report and Financial Statement and clearly sets out the operational targets as well as the outcome for the year which are directly linked to any performance bonus payments.

Under the current remuneration policy, payments for the two Executive Directors expressed as a percentage of base salary up to a maximum of 75% for the Finance Director and 100% for the Managing Director) (of which half is received as deferred Pennon Group Plc shares) are as follows:

- 37.5% / 50% profit before tax of Pennon Group Plc (incorporating South West Water)
- 7.5% / 10% for South West Water return on regulated equity (RoRE) performance
- 15% / 20% for the average of South West Water specific operational performance (in respect to targets which related to a range of ODI service standards, including the Service Incentive Mechanism)
- 15% / 20% for achievement of personal strategic objectives.

40% of the maximum bonus is linked to non-financial aspects, 10% is linked to performance against the regulatory allowances through the return on regulated equity (RoRE) where totex outperformance is shared with customers and ODI rewards reflect service benefits to customers. 50% of the bonus is linked to financial performance, which is a measure of the efficiency of the business.

As part of the Pennon Group, South West Water Directors are also eligible for the Pennon Long-Term Incentive Share Plan which provides alignment to the achievement of the strategic objectives and long-term value. This is based on specific financial metrics of the Pennon Group which reflect the long-term targets for the listed company.

South West Water's Executive performance related pay includes stretching operational targets and delivery of non-financial personal objectives. We will continue to transparently disclose the full details of Executive remuneration – including performance against regulatory targets.

South West Water discloses annually the performance of Executive Director's within the Annual Report and Financial Statement and clearly sets out the operational targets as well as the outcome for the year which is directly linked to any performance bonus payments.

WaterShare+ 2020-25

Since 2015, the South West Water Board pledge has been to share the benefits of success fairly between customers and investors.

Much of the regulatory mechanisms in place are already designed to achieve this, but the Board recognised that there were some circumstances where assumptions that were made for business planning that inevitably outturn differently, could result in financial benefits that should also be shared with customers, most significantly in those related to the macro-economic areas of interest costs and taxation rates.

South West Water's WaterShare framework enacted since 2015 has already been successfully sharing the net benefits of such outperformance. Specifically movements in market interest rates relative to the cost of new debt allowed in the period and changes in the headline tax rates relative to assumptions made have been aligned.

As a result for the period to 2020 the net additional financial benefits forecast to be shared with customers are c. £20m.

We are pleased that this groundbreaking approach has now been incorporated into the main regulatory methodology for PR19, and that customers may continue to benefit from future gains in this way.

In parallel, for this business plan to 2025, South West Water has again considered the regulatory mechanisms that are now in place, and whether there are other opportunities to ensure any additional net benefits arising from macro-economic changes are fairly shared with customers.

We fundamentally believe that there needs to be strong incentives for management to deliver and that investors are best placed to bear financing risks and consequently benefit from rewards in this area. However, we also consider the principle we have applied in our current delivery period of sharing with customers 100% of 'unearned' market movement gains arising from regulatory assumptions is important in driving transparency and legitimacy in this area. We believe this can be extended.

Our voluntary proposal for PR19 is that a mechanism consistent with our sharing principles can be used to share net financing outperformance relating to embedded debt, raised in previous regulatory periods.

The regulatory approach has consistently assumed for each successive business plan period that c. 25% of new debt is raised in a regulatory period. As such, for the period to 2025, mechanisms are in place that have already shared or will share any net gains from market movements for half of South West Water's debt.

South West Water has a predominance of floating rate debt that is fixed with financial hedges over a regulatory period. We are proposing that as our debt is fixed for the period 2020-2025, and any net benefits accrue, we will also share with customers the implied market movements for the embedded debt that has not already been subject to review.

To do this, we will retrospectively compare the cost of new debt allowance for historic periods PR04 (2005-2010) and PR09 (2010-2015) with the average annual outturn iBoxx indices in those periods. Any market driven financing outperformance related to the historic assumed new debt issuance in that period, will be shared with customers.

Assuming current market conditions for fixing debt prevails for South West Water, we have already estimated what we think this may deliver for customers.

Calculations of the outturn average annual 'A' and 'BBB' indices over PR04 (2005-2010) were slightly higher than Ofwat's cost of debt allowance of 6.6%, after the allowance for the cost of issuance. As a result, no outperformance was achieved in that period. (It should be noted this period included the credit crunch/ crisis which saw an increase in finance costs in particular for 2007/08 and 2008/09).

The same calculation process for PR09 (2010-2015) shows that the 'A' and 'BBB' indices out-turned at 5.1%, c1.4% lower than the assumed cost of debt allowance after the allowance for the cost of issuance for that period.

Using the regulatory assumption of 25% of new debt raised over each of the PR04 and PR09 regulatory periods results in c. £20m of financing outperformance, that may available to share with customers through to 2025.

We believe this approach is consistent with our principle of sharing 100% of market 'unearned' gains with customers whilst still preserving the incentives for management to efficiently raise finance and investors to appropriately bear risk in this area, and forecast a return that would be consistent with the returns to 2020.

We will also continue to apply our wider approach to truing up risks embedded in our WaterShare mechanism, to ensure that customers do not pay for uncertainty and risk in base prices ahead of a risk manifesting.

This approach continues to be supported by our customers and has been endorsed by the WaterFuture panel.

As our voluntary sharing mechanism has been successful and we are forecasting net benefits to share with customers, we have undertaken customer research to understand how customers would like to receive these financial benefits.

We have discussed bill reductions (immediate and deferred), monetary rebates, reinvestment in services and the option of being given an enduring 'financial stake' in the business that either is an equity share or has the properties of an equity share in the business.

South West Water, being a subsidiary of a listed company Pennon can also consider the option of enabling customers to own a true equity stake.

From customer research we have undertaken so far we have ascertained that whilst 77% of customers do not own shares or financial stakes in any company, 79% of customers believe share ownership would be a positive step.

It is seen as being a positive step as:

- Customers interests are intrinsically aligned with investors. Customers will receive a share of the company profits as and when shareholders do, in addition to owning a valuable capital stake
- Customers will have a direct say in the business through general meetings.

We have therefore concluded that despite the lack of familiarity of share ownership, there is perceived value in it. Many customers were aware of schemes that are available for employees and believe these are positive.

There was strong feedback that shares were a recognisable financial stake. With Pennon (South West Water's parent company) being listed on the FTSE 250, there is clear market for a financial stake with an identifiable market for trading.

We are finalising the option to offer to our household customers Pennon shares from 2020, and we will obtain further feedback from customers as to their preferences in this area.

Our Board commitment for this plan is to offer as an option alongside bill reductions, rebates and reinvestment, a financial stake in the business which is either a direct equity share of Pennon or share like scheme for South West Water which will mirror the properties of an equity share.

Irrespective of whether customers decide to opt for the financial stake in the business, the Board is also committing to:

- Having quarterly public customer meetings chaired by the independent chair of the WaterShare panel.
- Holding a customer AGM, with customers voting on the election of Panel members.

WaterShare+

We believe this approach moves the relationship with customers from engagement to empowerment.

Key messages

- Evolution of WaterShare to further support performance sharing and legitimacy
- Pioneering new sustainable financing framework with green loan principles, green bond principles and social bond principles giving access to future funding opportunities
- Transparent and open policies for dividends, taxation and executive remuneration
- Strong, independently assured evidence and Board assurance plan is financeable on notional and actual basis

Data assurance

The information provided in this report has been produced in accordance with our overall governance and assurance plan. Detailed analysis of our ratios and scenario testing is included within the business plan tables and line by line commentaries.

Our approach to financeability and financial resilience has considered a range of metrics and we have received external support and advice on this area, including a specific review by KPMG assessing our approach to Finance Resilience specifically.

Our submission builds on the methodology and approaches developed for, and since the 2014 Price Review and the submission for this 2019 price review has continued to focus on ensuring the long-term viability of the company.

Our financeability metrics and assessments have been prepared:

- Independently of other water and sewerage companies
- Taking into consideration the long-term risks of the business and has considered the impact on debt covenants
- To comply with the reporting requirements and line definitions, including adjustments, exclusions, additions and assumptions.

From a data assurance perspective our forecast financial metrics have been prepared by a dedicated team completing both our internal modelling and completing the Ofwat financial model. This information is then approved by the relevant Senior Manager and Director prior to submission.

This is reviewed by relevant Senior Managers, Directors and authorised at South West Water Board. Both the compilation and the review at Director level are undertaken by a regulatory expert, who understands the details of the business plan and Ofwat's requirements.

Summary – Initial assessment of plan questions

Risk & Return

RR 1 Has the company based the separate costs of capital that underpin each of its wholesale price controls, and the net margin(s) that underpins its retail price control(s), on those we state in our early view? If not, to what extent has the company robustly justified, in terms of benefits for customers, its proposed costs of capital and retail margin(s) within the context of expected market conditions for 2020-25?

For the cost of capital we have adopted the PR19 guidance:

- **RPI-linked part of the RCV:** 2.4% (RPI-real) for the appointed business and 2.3% for the wholesale business (deducting 10bp for the retail margin)
- **CPIH-linked part of the RCV:** 3.4% (CPIH-real) for the appointed business and 3.3% for the wholesale business (deducting 10bp for the retail margin).

We have used a 2% CPIH and 3% RPI, assuming a 100bp wedge between the two inflation rates, consistent with the position in the PR19 methodology. We have adopted the same cost of capital across all wholesale price controls.

For the residential retail EBIT margins we have used 1.0% which is consistent with the PR19 guidance.

RR 2 To what extent has the company demonstrated a clear understanding and assessment of the potential risks in its RoRE assessment, including the effect of the risk management measures it will have in place, across each of the price controls?

In stress testing the business plan we have considered the principal risks assessment and whether individual risks in isolation or in aggregate could impact on the financial viability of the business.

We have also considered the following scenarios:

- South West Water viability assessment – reference to South West Water's own identified risk register
- Scenario testing – scenarios which consider a range of probabilities (P10 / P90) with the detailed outputs reported in Business Plan table App 26 and based on RoRE performance expectations
- Ofwat's Financial Resilience tests – stress tests which are considered to assess the financial resilience in line with Ofwat's recent guidance.

We have undertaken the following steps in assessing the level of our risk:

- Provided a review of our principal risks which are linked to our long-term financial resilience statement
- Undertaken the risk modelling producing a P10/P90 RoRE range (presented as part of the Table – App26)
- Provided a detailed explanation of the modelling approach and the assumptions/analysis underpinning the quantum of the RoRE impacts
- Used historical data and business judgment to inform our assumptions as appropriate
- Have provided an explanation of the potential mitigation actions / preventive measures that we would put in place under the relevant scenarios and their potential effect.

Financeability

RR 3 Has the Board provided a clear statement that its plan is financeable on both an actual and a notional basis? Is the statement appropriate and how robust is the supporting evidence?

The Board has assessed the financial viability of the business with reference to the plan presented, and has a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due over the plan period to 2025.

Ensuring the financeability of the business is a strategic priority for the Board. The Board continually review the financial stability and viability of the business to ensure there is adequate funding headroom and protection for customers.

The Board has considered the key financial ratios and financeability of the overall business plan, balanced with customer affordability considerations. The Board has tested the financeability and affordability under different scenarios, identifying key risks and testing against ranges of possible outturns on cost and revenue drivers, operational performance, and the impact of regulatory incentives including ODIs.

The Board's approach is to attract and secure finance for the business at the minimum cost to our customers, including the balance between equity and debt, cost recovery assumptions and other factors.

The direct involvement the Board has had in this area of the plan has enabled the Board to be confident that the business plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in both the short and the long term. The Board has taken the following specific steps to assess the financeability of the plan:

- What are the key risks (and potential cost and revenue impacts)?
- What are the different scenarios possible post 2020?
- What are the impacts of regulatory incentives including ODIs?
- Is the plan affordable for customers?

In every potential scenario considered, the mitigation in place supports the statement that the plan is financeable and affordable for customers, giving adequate protection for customers in the short and long term.

As part of the transition to a new Licence following the merger with Bournemouth Water, shadow credit metrics are reviewed by South West Water. Whilst South West Water does not have an investment grade credit rating, South West Water targets specific covenant ratios to enable it to raise the debt in the most efficient way.

We have considered company analysis assuming that we will be continuing our operations without a credit rating and maintain the covenants relevant to our contractual obligations.

Projections indicate that there is ample covenant headroom over the 2020-25 regulatory period.

On both an actual and a notional basis the adjusted interest cover (which is a key financeability metric) is at a level consistent with an investment grade rating. Assessing the ratios before revenue adjustments for legacy performance improves the metrics further.

RR 4 How appropriate are the company's PAYG and RCV run-off rates? How well evidenced are they, including that they are consistent with customers' expectations, both now and in the longer term?

For this business plan to 2025, we have recognised in revenues the costs as they would naturally fall. This approach is aligned to the views of our customers and is based on their feedback against consequential bill profiles presented.

The run off rates recover a value equivalent to the current cost depreciation which would have been expected.

The PAYG has been derived from the operating expenditure plus the proportion of capital maintenance expenditure historically recognised under Infrastructure Renewals Expenditure (IRE). It excludes any pension deficit payments allowed.

We have considered whether the bill profile resulting from these rates is in line with customer feedback.

This resulting profile has been tested with customers, with overall acceptability to the profile being 88% from South West Water customers and 92% from Bournemouth Water customers.

High quality, ambitious and innovative plan

In addition to the summary responses to each of the initial assessment of plan questions noted here, we have provided further information evidencing the high quality, ambitious and innovative nature of our plan in the following section.

Further evidence can be located in a number of publications:

- South West Water PR19 suite of documents
- Other sources including South West Water documents and third party reports.

Summary – High quality, ambitious and innovative plan

High quality plan features	Evidence & activities	Evidence location within plan
Where business plans are underpinned by a different costs of capital and/or retail net margin(s) to our early view, we expect to see strong evidence to justify why it/they should be different within the context of expected market conditions for 2020-25	For the cost of capital we have adopted the PR19 guidance: RPI-linked part of the RCV: 2.4% (RPI-real) for the appointed business and 2.3% for the wholesale business (deducting 10bp for the retail margin) CPIH-linked part of the RCV: 3.4% (CPIH-real) for the appointed business and 3.3% for the wholesale business (deducting 10bp for the retail margin) We have used a 2% CPIH and 3% RPI, assuming a 100bp difference between the two inflation rates, consistent with the position in the PR19 methodology. We have adopted the same cost of capital across all wholesale price controls. For the retail EBIT margins we have used 1.0% (household tariffs).	● **Aligning risk and return** ● **Engaging customers** ● **WaterFuture Customer Panel report**
The company will demonstrate they have a clear understanding of the risks that could affect delivery of the plan, including through RoRE scenario analysis, and that they have appropriate risk management practices in place	In stress testing the business plan we have considered the principal risks assessment and whether individual risks in isolation or in aggregate could impact on the financial viability of the business. We have also considered the following scenarios • South West Water viability assessment - reference to South West Water's own identified risk register • Scenario testing - scenarios which consider a range of probabilities (P10 / P90) with the detailed outputs reported in Business Plan table App 26 and based on RoRE performance expectations • Ofwat's Financial Resilience tests - stress tests which are considered to assess the financial resilience in line with Ofwat's recent guidance. We have undertaken the following steps in assessing the level of our risk: • Provided a review of our principal risks which are linked to our long-term financial resilience statement • Undertaken the risk modelling producing a P10/P90 RoRE range (presented as part of the Table – App26) • Provided a detailed explanation of the modelling approach and the assumptions/analysis underpinning the quantum of the RoRE impacts • Used historical data and business judgment to inform our assumptions as appropriate • Provided an explanation of the potential mitigation actions / preventive measures that we would put in place under the relevant scenarios and their potential effect.	● **Aligning risk and return** ● **Engaging customers** ● **Board assurance statement** ● **Securing long-term resilience** ● **Securing trust, confidence and assurance** ● **Appointee summary** ● **WaterFuture Customer Panel report** ○ **Business planning tables and commentary – App 26** ○ **KPMG financial resilience assessment** ○ **Annual performance report 2018**

High quality plan features	Evidence & activities	Evidence location within plan
The company will demonstrate and provide assurance that it is financeable under both the notional and actual capital structure. The company will clearly explain the PAYG and run-off levers it has used. Where used to address financeability it will demonstrate these are for maintaining the financeability of the notional rather than actual structure	As part of the transition to a new Licence following the merger with Bournemouth Water, shadow credit metrics are reviewed by South West Water. Whilst South West Water does not have an investment grade credit rating, South West Water targets specific covenant ratios to enable it to raise the debt in the most efficient way. We have considered company analysis assuming that we will be continuing our operations without a credit rating and maintain the covenants relevant to our contractual obligations. Under the current arrangements, SWW monitors and maintains the following 'tightest' covenants: • EBITDA P&L interest cover (min. of 2.5 times) • Regulatory gearing (max of 70%). Projections indicate that there is ample covenant headroom over the 2020-25 regulatory period. On a notional basis the adjusted interest cover (which is a key financeability metric) is sufficient for an investment grade rating. In line with Ofwat's guidance the ratios for financeability are considered both before and after adjustments for past performance. Reviewing the ratios before revenue adjustments for legacy performance gives metrics that improve the position for an investment grade credit rating.	● **Aligning risk and return** ● **Engaging customers** ● **Board assurance statement** ● **Securing long-term resilience** ● **Securing trust, confidence and assurance** ● **Appointee summary** ● **WaterFuture Customer Panel report** ○ **Business planning tables and commentary – App 26** ○ **KPMG financial resilience assessment** ○ **Annual performance report 2018**
The company will provide strong evidence to support its PAYG and RCV run-off rates, including whether they are consistent with customers' preferences, both now and in the longer term	For this business plan to 2025, we have recognised in revenues the costs as they would naturally fall. This approach is aligned to the views of our customers and is based on their feedback against consequential bill profiles presented. The run off rates recover a value equivalent to the current cost depreciation which would have been expected. The PAYG has been derived from the operating expenditure plus the proportion of capital maintenance expenditure historically recognised under Infrastructure Renewals Expenditure (IRE). It excludes any pension deficit payments allowed. We have considered whether the bill profile resulting from these rates is in line with customer feedback. This resulting profile has been tested with customers, with overall acceptability to the profile being 88% from South West Water customers and 92% from Bournemouth Water customers.	● **Aligning risk and return** ● **Engaging customers** ● **Board assurance statement** ● **Securing trust, confidence and assurance** ● **Securing long-term resilience** ● **Appointee summary 2050 Vision** ● **WaterFuture Customer Panel report** ○ **Business planning tables and commentary – App 26** ○ **KPMG financial resilience assessment** ○ **Annual performance report 2018** ○ **ICS customer acceptability research report**

Appendices

Customer research and engagement

Customer engagement on aligning risk and return

Alongside our regular engagement on transparency of information and performance with our customers, we have actively engaged on topics such as corporate responsibility and development of our taxation strategy.

Our engagement with our customers hasn't stopped since the last price review; in fact it has been the springboard to even greater engagement with customers through our WaterShare mechanism.

WaterShare performance is published yearly and with it we seek customer views on our how any cost savings should be treated, giving them ultimate control in how their money is spent or returned.

An annual survey informing customers of WaterShare, the cost savings available and what that is equivalent to as a one-off bill reduction is undertaken, we then present options (lowering bills, deferring to offset bills in the future, re-invest in improving services or a mix of the options) and ask for customers to rank their preferences. This research is reported to the WaterShare Panel to discuss and agree next steps based on customer views. We publish the action taken on our website but also communicate how any out or under performance payments are applied to bills.

We have continued the conversation with customers on 'WaterShare' to see how it can be improved and developed for 2020-2025. The activities have included:

WaterShare+ Principles

South West Water customers benefit from the WaterShare scheme whereby any outperformance of the 2015-20 business plan is shared with customers. This survey aims to understand customers' views on the approach to the WaterShare scheme from 2020 known as WaterShare+ and specifically the principles and broad approach to rolling out share ownership to customers.

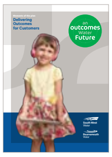
The WaterShare Package

South West Water customers benefit from the WaterShare scheme whereby any outperformance of the 2015-20 business plan is shared with customers. South West Water has engaged with customers considerably on the successor to WaterShare, known as WaterShare+. This has set out the principles and broad approach to rolling out share ownership to customers. This study focused on understanding customers' views on the proposed package and the barriers that may prevent take up across the customer base.

Building trust, supporting customers and sharing success

The aim of this research was to understand more about affordability and value for money; how we support customers that are less well off and struggle to pay their bills; and how we share success in the future through cost savings and share ownership (WaterShare+).

We have carried out a robust programme of engagement on setting performance commitments, levels and incentives as part of PR19. We have calibrated our incentives to align with customer views. We are confident we have the right balance of incentives and the right level of protections in place.



For more information, see
Delivering Outcomes for Customers

In our WaterShare+ Principles research we asked customers about bill volatility. This included presenting choices over bill profiles – overwhelmingly customers told us that large bill reductions followed by steep rises are not popular; neither are bills that go up or down to match investment or performance. Customers prefer more smoothed bills – ideally beyond the 5 years period.

Acceptability and affordability of the plan

All of the research that we have undertaken has put the customer at the heart of our business plan. The final checks and tests on what we have heard and how we have reflected this in our plans has been our acceptability testing.

In the quantitative testing phase, in real terms 92% of households in our Bournemouth Water region found the plans to be acceptable (79% at PR14). With the sewerage bill explained in real terms acceptability is still high at 91%. This confirms our plan is the right balance of investment and bills.

For South West Water customers the acceptability of the plan in real terms is 88% (84% at PR14) again demonstrating a high level of customer support for the business plan. In fact all the proposed initiatives had high levels of support ranging from 81%-91%.

As part of the acceptability testing South West Water customers were asked their views on the affordability of their current bill and their expectations around affordability of the 2020-25 plan. 75% of customers perceive their current bill to be affordable, this figure drops slightly to 73% for the 2020-25 plan with the main concern being inflation and its impact on their incomes. Customers told us that inflation concerns them. More so than in PR14, with 35% of customers telling us their wages and incomes are rising by less than inflation each year – and they worry about water bills that rise faster than their incomes.

For Bournemouth customers, concerns around affordability of their current and future bill were less at 89% and 87% respectively.

WaterFuture Customer Panel engagement and assurance

The WaterFuture Customer Panel (WFCP) is made up of representatives from customer, business, stakeholder and regulatory organisations and its role is to provide the independent challenge to companies and independent assurance to Ofwat on:

- The quality of a company's customer engagement; and
- The extent to which the results of this engagement are driving decision making and are reflected in the company's plan.

The Panel also set up two sub-groups to work more closely with the company on research, engagement and vulnerability activities; the Research, Engagement and Vulnerability (REaV) sub group, and on legislative and statutory obligations; the Legislative, Resilience and Environmental Investment (LREI sub group) with both chaired by a member of the WaterFuture Customer Panel.

The WFCP and both sub groups were engaged from the outset of our journey in developing stretching performance commitments and outcome delivery incentives, and provided scrutiny and challenge throughout the process.

We held a dedicated workshop for the WFCP, LREI and REaV focused on providing further insight into our valuation strategy, which formed the basis of our package of ODIs. The WFCP were impressed with the transparency of the information provided at the workshop, commenting that they had not seen anything as transparent as this in the industry before. These workshops helped to illustrate how customer priorities and the values that customers ascribed to the improvements in service, were used in developing our ODIs.

We discussed with the WFCP and both subgroups the findings from our 'risk and reward' research, in which we asked customers about all of the factors that we needed to consider in order to create a balanced package of ODIs. This included many aspects including: outperformance and underperformance payments, asset health incentives, deadbands and the overall RoRE range, with the outputs of this research scrutinised by the REaV sub group

The WFCP reviewed the overall package of ODIs, illustrating the split of outperformance and underperformance payments, along with the maximum range for payments each year and over the five year period, which they were supportive of. We highlighted that this range included the areas where customer support for enhanced payments, for exceeding or failing our targets, was strongest.

The WFCP challenged our total ODI range, which we set in line with Ofwat's methodology, and in line with customer views, who told us that the RoRE range should not exceed 3%. Customers also told us that they were supportive of enhanced rates for out/under performance, with the bigger the failure of a target, the more the penalty should be, and likewise with outperformance payments for exceeding target. In setting our maximum range at +/- 3% of RoRE, we confirmed that our final range was based on the research validated through the REaV sub group, with the WFCP satisfied that all values had been comprehensively triangulated. The WFCP challenged the way in which customers would be protected from the associated bill volatility of this package. We shared with the WFCP that our WaterShare mechanism would remain in place, but would be enhanced to empower customers and give them a greater say in our business. In line with how the WaterShare Panel operates now, the panel will continue to independently scrutinise our actual and forecast performance, and based on research into customer preferences, the Panel will review our approach to sharing customer benefit and the timing of any net gain.

We also shared the customer research on WaterShare+ with the WFCP, who challenged whether we felt the outputs of this research were representative of customers in our region. We confirmed that all research was carried out in line with the sampling strategy which was developed with the REaV sub group, and that we were confident that the sample used for this survey was representative. The panel were satisfied that this mechanism will continue to protect customers from bill volatility in 2020-25, as it does currently.

We discussed with the WFCP and both sub groups the requirement for our package of risk and reward to be balance, and shared each version of this package with the panel and sub groups for review and challenge as it was further developed. Our final ODI package is slightly biased toward underperformance payments, or penalties, over outperformance or reward payments, in light of the fact that some of our ODIs are penalty only, such as our category 3 and 4 pollutions which prompted debate and challenge amongst panel members. The Environment Agency were particularly supportive of this commitment being penalty only which is reflected in our final package.

The WFCP also discussed the proportion of our ODIs related to asset health which reflected 24% of potential underperformance payments, and 25% of potential outperformance payments. The panel understood that customers believed that asset health and service are equally important to incentivise, and were satisfied that range of asset health incentives within the package were reflective of this.

In providing the panel with confidence in the strength of our corporate governance, for transparency we wanted to share our approach to dividend payments with the WFCP to allow them to express any views on this. We confirmed that our approach is aligned with Ofwat's methodology and guidance and as such have no further plans to change it, which the WFCP were happy with and raised no objections.

Overall, the panel felt that the research carried out with customers in balancing risk and reward was reflected in our final ODI package and business plan.

"We think the company are doing the right thing with having pollutions as a penalty only target."

Jeremy Bailey
Environment Agency

"The balance of incentives around asset health feels proportionate."

Richard Lacey
WaterFuture Customer Panel

Board assurance

Risk and return

In 2013 the Board pledged to transparently report performance and to share the risk and return fairly between customers and investors. This remains a core value of the Board.

The Board oversees a well established fully integrated risk and assurance governance framework that has delivered a reliable and resilient service for our customers. All aspects of the risk and return package are reviewed and scrutinised by the Board as part of this framework.

The Board oversight has enabled outperformance on all elements of the risk and return package even when unexpected events occur. The Board regularly review scenarios, assessing potential risks and mitigating impacts.

In PR14 the Board created the WaterShare mechanism and framework as an innovative way of fairly sharing the benefits of risk and reward between customers and shareholders. Alongside a Board pledge to keep bill rises below inflation this has been has been a huge success in providing a backstop protection for customers.

After further engagement with customers we are applying the principles of WaterShare to include Bournemouth Water customers for the first time and also an unprecedented move of developing the WaterShare benefits into a customer share ownership scheme. This will provide even greater alignment between customer and shareholder interests and sharing of risk and return. The Board believe that 'unearned' gains should be returned to customers in full.

Customers have been engaged on all elements of the proposed risk and return package and show strong support for the proposed package. The establishment of a sharing mechanism for outperformance on the cost of embedded debt further enhances customers views and acceptance of the proposed risk and return package.

The Board has also attended customer focus groups and workshops to hear feedback first hand and customer views on the risk and return package.

Detailed analysis of financial scenarios have been reviewed by the Board to confirm the operational, corporate and financial resilience of our business and PR19 plans. This assertion is reaffirmed by independent expert analysis.

For more information, see
Securing Long-Term Resilience

This direct involvement in this area of the plan has enabled the Board to be confident that **the Board has identified the risks associated with delivering the plan and also the mitigating activities and management plans to reduce the risks to acceptable levels agreed with our customers.**

This is included in our signed Board assurance statement.

For more information, see

Board Assurance Statement

Securing Trust, Confidence & Assurance

Financeability

Ensuring the financeability of the business is a strategic priority for the Board. The Board continually review the financial stability and viability of the business to ensure there is adequate headroom and protection for customers.

The Board has considered the key financial ratios and financeability of the overall business plan, balanced with customer affordability considerations. The Board has tested the financeability and affordability under different scenarios, identifying key risks and testing against ranges of possible outturns on cost and revenue drivers, operational performance, and the impact of regulatory incentives including outcome delivery incentives (ODIs).

The Board's approach to attracting and securing finance for the business at the minimum cost to our customers, including the balance between equity and debt, cost recovery assumptions and other factors that have a significant impact on financeability constraints is described in the 'aligning risk and return' element of our plan.

This direct involvement in this area of the plan has enabled the Board to be confident that **the business plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in both the short and the long term. The Board has taken the following specific steps to assess the financeability of the plan:**

- **What are the different scenarios possible post 2020?**
- **What are the key risks?**
- **What potential cost impacts?**
- **What are the potential impacts on revenues?**
- **What are the impacts of regulatory incentives including ODIs?**
- **Is the plan affordable for customers?**

In every potential scenario considered the plan is financeable and affordable for customers, giving adequate protection for customers in the short and long term.

This is included in our signed Board assurance statement.

For more information, see

Board Assurance Statement

Securing Trust, Confidence & Assurance

Professional credentials of third parties

Oxera

Oxera is a leading independent economics consultancy. They advise companies, policymakers, regulators and lawyers on any economic issue connected with competition, finance or regulation. They have been doing this for more than three decades, gathering deep and wide-ranging knowledge as they expand into new sectors. They have a reputation for credibility and integrity among those they advise, and among key decision-makers, such as policymakers, regulators and courts. Today they have offices in Oxford, Berlin, Brussels, London and Rome and are able to advise international clients in a highly flexible way, including providing advice in several other languages.

KPMG

KPMG is a leading provider of professional services, including audit and advisory solutions integrating innovative approaches and deep expertise to deliver real results. They have extensive water industry experience.

They have worked with South West Water over a number of years, acting as financial advisor at PR14 as well as reviewing retail margins, default tariffs and providing retail modelling advice.

KPMG has advised extensively on financeability issues and financial resilience. Their team has a unique combination of financial analysis skills, combined with regulatory finance and corporate finance expertise; with experience of advising on financial structuring, financial strategy and financial resilience.

Frontier Economics

Frontier Economics is Europe's leading specialist economics consultancy that uses economic principles and tools to provide practical solutions to complex problems. They have over 120 consulting staff and associates based in London, Brussels, Cologne, Dublin and Madrid. Together with Frontier Economics Pty located in Melbourne and Sydney (Australia), they work globally for senior decision-makers in government and private sector, including leading businesses and international financial institutions. Frontier has particular expertise in the economic regulation of network industries, with wide experience of regulation in many jurisdictions across all of Europe, and the rest of the world. Their areas of specialism cover designing regulatory instruments, modelling incentives, efficiency benchmarking and cost modelling, financial modelling, and cost of capital assessment. They have advised UK utilities in numerous price control reviews.

a shared Water Future

South West Water

Bournemouth Water

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