

Business Plan 2020-2025

Response to Ofwat's July 2019 Draft Determination for Slow-track Companies

Overview



**South West
Water**



**Bournemouth
Water**

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Executive Summary

1. We received our Draft Determination in April this year and we were pleased that our plan was recognised by Ofwat as high quality and that overall the Draft Determination broadly aligned with our original PR19 submission for 2020-25 which was well supported by our customers and stakeholders.
2. We responded accordingly, asking Ofwat to consider some notable items to ensure that South West Water can continue to deliver for customers, environment, investors and wider society. Those representations related to the treatment of cost base assessments for the proposed Isles of Scilly expanded Licence area, the approach to calculating South West Water dividend yield and a challenge regarding the enhanced Outcome Delivery Incentive (ODI) rate for internal sewer flooding. Having accepted a number of challenges through the Initial Assessment of Plans (IAP) process, we limited our Draft Determination representations on the presumption that as a fast-tracked company there would be minimal changes through to the Final Determination.
3. We note however that the Draft Determinations for slow track and significant scrutiny companies which were issued in July also include aspects that have had a significant impact on South West Water's business plan, notably as a result of Ofwat's updated view on the sector's cost base and cost of capital allowances as well as contiguous companies new scheme investments. It is also clear that there may yet be further adjustments ahead of the Final Determination.
4. As such having reviewed the implied impacts for South West Water, we are updating our previous Draft Determination representations to encompass those new aspects.
5. The South West Water Board has reviewed the key aspects of the implied impacts to South West Water's business plan arising from Ofwat's updated views in July and has approved the approach to the representations submitted.
6. We have discussed these representations with our WaterFuture Customer Panel (WFCP). The WFCP has fully supported the company's approach throughout the price review process and is supportive that the company's representations are in the customer's best interests to ensure that the company can continue to maintain and improve the services to customers in the areas that matter most.
7. We are providing evidence and support for the following Totex aspects which we would expect Ofwat to take into account ahead of the Final Determination:

Additional evidence to support expenditure on specific schemes (e.g. Isles of Scilly) and schemes included within the enhanced categorisation of the South West Water business plan	£93.1m
Special Totex claims for South West Water to support: <ul style="list-style-type: none"> • expenditure associated with the maintenance of bathing water quality in the region (UV) • the specific nature and approach to growth development (and the pertinent drivers for costs) in our region - e.g. sizing of wastewater treatment works 	£13.6m £28.8m
Totex impact of other company schemes which have changed since business plan submission e.g. the Southern Water transfer which has increased by a further 10 ml/d and has a consequential impact on sizing of the Bournemouth Water treatment works	£7.8m

8. In addition to the Totex representations, we have also reviewed Ofwat's approach to calculating the cost of capital. We believe there are challenges to Ofwat's methodology approach and interpretation of data points.
9. We also note that using Ofwat's current view of the cost of capital, there would be an impact on South West Water's financeability ratios. Whilst we do not have receipt of Ofwat's updated financial model for South West Water, we have reviewed the implied impact of the reduction in the cost of capital and further challenge to cost base. Inevitably these have a detrimental impact on the financial ratios and level of headroom for the business to manage financial shocks in the period to 2025.
10. To support our representations, we have engaged third party expertise, support and where appropriate we have included those independent reports for review and consideration.
11. We note that despite having a fast-tracked plan there may well be adjustments in the Final Determination that have a material impact on customer bill profiles and we would appreciate the opportunity to discuss profiles with our WFCP and agree an appropriate approach at that time ahead of 2020/21 billing.
12. This document summarises our representation covering the following key areas; Aligning Risk and Return, Securing Cost Efficiency, Delivering Outcomes for Customers and Accounting for Past Delivery, and is further supported by a number of documents setting out the technical evidence for Ofwat to assess.

Ongoing representation following fast-track Draft Determination

13. As a fast-tracked company, representations have already been made on South West Water's early Draft Determination received in April this year. A brief overview of our earlier representation for each is as follows:
- **Dividend yields** - we are seeking to reflect dividends consistent with the returns within revenue to ensure that the gearing levels at a notional level are more aligned with the PR19 methodology
 - **Isles of Scilly** - we are asking for Ofwat to consider how to treat the Isles of Scilly which will include ongoing dialogue on the costs, using the WaterShare+ framework to monitor delivery and provide enhanced sharing rates with customers in the event that the investment profiled over the five years is delivered for less than the original assumptions. If the Isles of Scilly are treated in this way, we believe that the performance commitment should be removed as it will double count the financial incentives/share to be returned to customers
 - **Internal sewer flooding enhanced outperformance rates** - we are asking Ofwat to reconsider the Draft Determination intervention to reduce the enhanced outperformance incentive rates on internal sewer flooding.
14. We note the points raised in our previous consultation response are still to be finalised as part of the Final Determination, our representation on Dividend Yields is still relevant but we are providing additional information to support the Isles of Scilly claim. Additional areas of investment have already been identified since the Business Plan was submitted in September 2018 and therefore evidence is being provided to support the original cost claim in full. [REDACTED]
- [REDACTED]
- [REDACTED]
15. We have also updated the evidence to support our representation on internal sewer flooding enhanced outperformance rates having reviewed the Ofwat approach to quantifying the benchmarking externality for enhanced ODI rates included within Delivering outcomes for customers policy appendix published in July.

Aligning risk and return

Cost of capital

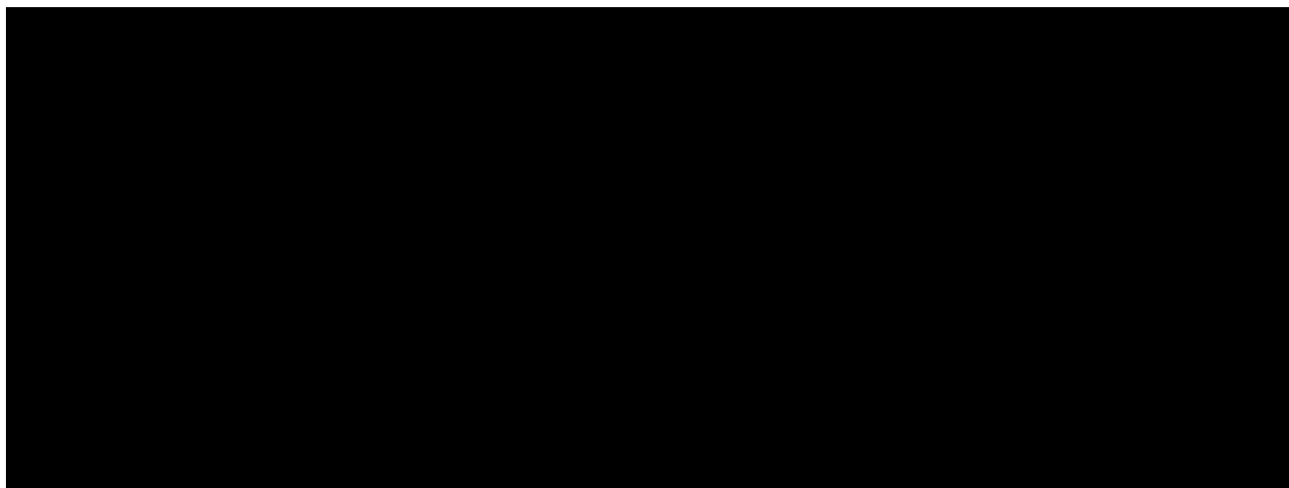
16. Consistent with our approach to our Business Plan we have commissioned a third-party report (Frontier Economics) to provide us with an independent assessment of the cost of capital following Ofwat's latest view.
17. The assessment considers each aspect of the methodology used for the slow-track Draft Determinations issued in July and considers market data points.
18. Specifically, we have considered the approach with reference to:
 - PR14 assumptions and approach taken, including the CMA decisions on Bristol Water
 - Regulatory precedent and recent reporting
 - Current market assessments.
19. We believe the approach taken for the July Draft Determinations is not consistent with regulatory precedent and we also have considered recent market information, both of which would imply a higher point estimate for the weighted average cost of capital.
20. Overall, we believe a point estimate for the cost of capital is 59 bps higher than Ofwat's assumptions within the slow-track Draft Determinations. This is based on independently commissioned work from Frontier Economics.
21. Frontier's estimate addresses questions of methodology which have arisen as part of the Draft Determination, and provides market updates in relation to Ofwat's view at Draft Determination on 28 February 2019 (based on updated information to the end of July 2019).
22. Frontier derive a point estimate of 2.67% for the vanilla weighted average cost of capital (WACC) in RPI real terms. This is 59 bps higher than Ofwat's Draft Determination.

(Real RPI)	Frontier Assessment	Ofwat's Assessment
Cost of equity:	4.63%	3.46%
Cost of debt:		
<i>Nominal cost of embedded debt</i>	<i>1.61%</i>	<i>1.46%</i>
<i>Nominal cost of new debt</i>	<i>0.63%</i>	<i>0.35%</i>
Real overall cost of debt	1.55%	1.34%
Appointee WACC	2.78%	2.19%
Retail net margin deduction	0.11%	0.11%
Wholesale WACC (vanilla)	2.67%	2.08%

23. The differences in the point estimate are driven entirely by differences in methodology, with all market data being derived in line with Ofwat's cut-off date at Draft Determination of 28 February 2019. These methodological differences are as follows:
- **Total market return:** Ofwat no longer focuses on DGM (Dividend Growth Model) analysis, but puts equal weight on ex-post, ex-ante and forward-looking approaches. While we agree with this view, we estimate a range of 6.5%-7.2% (in real CPIH terms), in line with that used by the CMA for its decisions on Bristol Water and Northern Ireland Electricity (NIE). Frontier propose a point estimate at the top of this range, having regard to regulatory consistency, reflecting the absence of evidence to support a material change from PR14, and to preserve neutrality from the switch to CPIH
 - **Risk-free rate:** Ofwat has changed its approach and relies on the average of spot yields for 10 and 20-year index-linked gilt yields. Frontier maintain an approach in line with that taken by Ofwat at its early view, and use the six-month average of 15-year nominal gilts
 - **Asset beta:** Ofwat rely on a single point estimate based on two-year daily data, estimating a range using different estimation windows and data frequencies. This approach is in line with recent regulatory precedent, such as the approach adopted at PR14, and by the CMA for Bristol Water and NIE. Frontier adopt Ofwat's updated debt beta estimate. It is our view that the traditional approach to the EV/RCV gearing adjustment is the most reasonable approach
 - **Ratio of embedded to new debt:** a review of the resubmitted business plan table data results in a lower estimate of 16% new debt in comparison with that used by Ofwat at the July Draft Determinations of 20%
 - **Cost of embedded debt:** this methodology does not include the reduction from expected outperformance (the so-called 'halo' effect) on the cost of new issuance up to 2020, as we do not see sufficient evidence of its existence. Frontier also adopt an updated approach to estimating forward uplift adjustment
 - **Cost of new debt:** as for embedded debt, Frontier removed Ofwat's halo adjustment and apply an updated approach to estimating the iBoxx rate and forward uplift.
24. Frontier has identified differences with Ofwat due to market movements and methodological approaches.
25. Frontier also identify factors that would suggest that the true cost of capital could lie towards the upper end of the range. This is supported by the evidence on overall cross-checks of the cost of equity, including DGM.
26. A copy of the full report by Frontier is included within the suite of additional supporting information provided alongside this representation.
27. In summary, we believe both for the cost of equity and the cost of debt, that Ofwat should consider both a top down cross-check as well as a bottom up calculation for the WACC given the uncertainty in estimating some of the parameters. For example, whilst Ofwat's approach does not put any weight to the market to asset ratios, the fact that these have fallen is indicative of political risk – which has always been a valid and material risk in the sector.
28. In conclusion, we do not believe that the WACC has declined since the early view nor that a further reduction from the Draft Determination is warranted.

Return of Regulated Equity – Risk Range

29. At the fast-track Draft Determination, Ofwat did not require any actions or changes to our Return on Regulated Equity (RORE) approach and analysis. The only change in value reflected the actions associated with ODIs and the range of potential under/out performance.
30. Similarly, following the information on ODIs implied from the slow-track Draft Determinations we have updated our RORE risk range to reflect these changes.



31. Overall the RORE range has changed reflecting the movements within the ODIs. Whilst the implied totex allowances have reduced, South West Water is making a number of representations relating to both base and enhanced expenditure and therefore has not changed expectations on the potential range for under/out performance on totex (including retail).
32. In addition, the overall cost of debt has not changed in Ofwat's updated view of the cost of capital. As a result, we have not changed our assumed RORE outperformance assumed for potential financing under/out performance.

Financial Resilience

33. Using Ofwat's current view of the cost of capital and the implied updates for the latest view on totex allowances, there would be an impact on South West Water's financeability ratios.
34. As a fast-track company we have not received Ofwat's updated financial model for South West Water. We have however, reviewed the implied impact of the reduction in the cost of capital and further challenge to the cost base.
35. Based on our fast-track Draft Determination models in April 2019 and assessing the impacts of reduction in the cost of capital and further challenge to cost base, inevitably these have a detrimental impact on the financial ratios and level of headroom for the business to manage financial shocks in the period to 2025.

For more information see additional information document: [Aligning Risk and Return – supporting information](#)

Securing Cost Efficiency

36. Since the Initial Assessment of Plans (IAP) and South West Water's Draft Determination in April further assessments of enhanced expenditure and changes in the base modelling approach (to incorporate growth investment) have been undertaken, alongside additional information, representations and submissions from other companies. Ofwat's latest view of totex was published as part of the Draft Determinations for slow track and significant scrutiny companies in July.
37. Having accepted a number of challenges through the IAP process, we limited our Draft Determination representations on the presumption that as a fast-tracked company there would be minimal changes through to the Final Determination.
38. However, Ofwat's latest view of totex implies a further adjustment to South West Water's totex allowances for 2020-25. Overall this has reduced South West Water's totex allowance by c.£125m (c.6% of our overall totex allowance including retail). As a result, we are updating our previous Draft Determination representations to encompass the aspects of Ofwat's latest view.
39. We are representing on a number of areas – giving further information and evidence to support our existing cost claims and items for consideration. The key areas are:
- **Enhancement Totex representations** – providing additional evidence to support our enhanced totex within the business plan, including those which were included within our special cost factor claims
 - **Special Totex claims** – three new totex claims associated with wastewater base modelling and growth modelling in both water and wastewater
 - **New additions to the business plan** – representations on the additional totex for the strategic regional water resources solution and the impact of water transfers to the South East.
40. The totex representations we are making are summarised in the table below with the comprehensive supporting information and evidence included in our 'Securing Cost Efficiency' representation document:

	Total £m
Evidence for existing base and enhancement totex	£93.1m
Special Totex claims	£42.4m
New additions to the business plan	£7.8m

Summary of Totex Adjustments

41. Since the business plan submission in September 2018 there have been a number of adjustments in both the totex allowances and the allocation of base and enhanced expenditure.
42. The base (and now growth) modelling completed and a review of enhanced expenditure through modelled allowances, industry comparisons and deep dives of key areas of expenditure, has resulted in changes in the totex allowances.
43. At the initial assessment of plans Ofwat totex allowances reduced by £67m and the latest view following slow-track Draft Determinations implies a further reduction in totex of £38m plus an additional £20m reduction of water new connections growth expenditure, which was included within third party services in our business plan but has been assessed in base + growth for the latest position.
44. The table below outlines the key movements:

	Business Plan £m	IAP totex Adjustment £m	April Fast-track DD £m	Growth Allocation £m	July totex Adjustment £m	July implied view £m	Total Adjustment £m	Ref
Water								
Base	652	70	722	47	(13)	756	57	Para 51
Enhanced	254	(74)	180	(47)	-	134	(74)	Para 46
TOTEX	906	(4)	902	-	(13)	890	(17)	
Wastewater								
Base	716	(28)	688	88	(18)	758	(46)	Para 51
Enhanced	267	(16)	251	(88)	(7)	156	(23)	Para 47
TOTEX	983	(44)	939	-	(25)	914	(69)	
Retail	160	(19)	141	-	-	141	(19)	-
Appointee TOTEX	2,049	(67)	1,982	-	(38)	1,945	(105)	
Third party costs	20	-	20	-	(20)	-	(20)	Para 51

Note: Rounding difference to total from July published 'Security Cost Efficiency Technical Appendix'

Enhancement & Base Totex Representations

45. The movements in enhanced expenditure, when considered through shallow and deep dive assessments, were substantial within both the water and wastewater areas. The table overleaf sets out the basis for these cost challenges – reflecting the individual activity outlined in our business plan and where these assessments were allocated and reviewed by Ofwat.
 - **Revised Representation** – reflects the value that we are including within our representation
 - **Implied Totex Adjustment** – is the total cost adjustment from the business plan to Ofwat's latest view of cost assessments identified through the enhanced feder models.

46. The table below sets out the areas for the Water revenue controls where additional information and evidence has been provided to support these representations for enhanced expenditure.

Water

		OFWAT ASSESSMENT AREAS ALLOCATION							
SWW BUSINESS PLAN AREAS	Water Enhancement Totex (£m)	Revised Rep'n	Implied totex Adjustment	Raw water deter'n	Resilience	DW protection	Taste and odour	Other / Freeform	Enhanced Opex
	Knapp Mill/Alderney WTW	11.1	11.1	4.4	6.7				
	Catchment management	4.9	4.9	3.8		1.1			
	Resilient Service Improvement (RSI)	10.0	10.0		10.0				
	Leakage	8.4	11.2					7.2	4.0
	Isles of Scilly (IoS)	1.6	1.6					1.6	
	Q schemes - WTW	12.1	12.1	9.3					2.8
	Mains replacements	1.5	1.5				1.5		
	Valve maintenance	2.9	2.9					2.9	
	Meter replacements	5.0	6.4					6.4	
	Treatment works improvements	7.3	7.3					7.3	
	Cullompton Service Reservoir	4.0	4.0					4.0	
	Other minor areas	-	1.1					0.1	
	TOTAL	68.7	74.0	17.5	16.7	1.1	1.5	29.5	6.8

- **Knapp Mill / Alderney** – as part of the business plan query process we included additional evidence to support the special totex claims for Knapp Mill and Alderney new water treatment works. We have reconfirmed this position and provided further evidence in this representation
- **Catchment Management** – we have provided additional information to support the full enhancement costs within this area, including comparisons of efficient costs
- **Resilient Service Improvement (RSI)** – we provided additional commentary on the activities associated with this programme and the basis for the enhanced costs
- **Leakage** – whilst we recognise the standard approach taken within the modelling we have provided additional information and support for the small proportion of leakage totex included as enhanced expenditure
- **Isles of Scilly (IoS)** – a proportion of this investment was disallowed due to the perceived ‘optimism bias’ within the cost base. Since the business plan submission, we have continued engagement with our regulators on the expansion into the IoS and have already identified specific additional expenditure and requirements
- **Q Schemes** – we provide additional evidence to address Ofwat’s concerns regarding ‘best options for customers’ and ‘robustness and efficiency of costs’. Specifically, we demonstrate how we have evaluated all options for resolving the issues of raw water deterioration, consistent with our engagement with the DWI, and that our costs are efficient
- **Mains Replacements** – we provide additional evidence to demonstrate that our investment is targeted at reducing discolouration remobilisation risk through mains replacement which is outside of ‘management control’. We also demonstrate that our costs are efficient by providing a bottom-up breakdown
- **Valve Maintenance** – we demonstrate that the investment is for new schemes and more advanced control equipment which is enhancement rather than underlying base maintenance
- **Meter Replacements** – the majority of these costs were assumed to be within the base allowances, however the enhancement spend specifically relates to the investment and deployment of smart meters

- **Treatment Works Improvements** – we demonstrate this investment is enhanced as it is directly linked to the requirement to comply with the new Network & Information Systems (NIS) regulations
- **Cullompton Service Reservoir** – this investment was reallocated to ‘New development and growth’ and then subsequently considered within base modelling. We are providing additional information to support that the nature of these new developments, as part of the Governments Garden Village programme are specific and therefore should be considered enhancement investment.

47. The table below sets out the areas for the wastewater revenue controls where additional information and evidence has been provided to support these representations for enhanced expenditure.

Wastewater

				OFWAT ASSESSMENT AREAS			
SWW BUSINESS PLAN AREAS	Wastewater Enhancement (£m)	Revised Rep'n	Implied totex Adjustment	Other / Freeform	Growth	Sludge	Enhanced Opex
	Isles of Scilly (IoS)	1.4	1.4	1.2			0.2
	Downstream Thinking	9.7	9.7		9.7		
	Sludge	1.5	5.2			5.2	
	Sewer pumping stations	7.9	7.9	7.9			
	Other minor areas	-	-0.9	-0.9			
	TOTAL	20.5	23.3	8.2	9.7	5.2	0.2

- **Isles of Scilly (IoS)** – a proportion of this investment was disallowed due to the perceived ‘optimism bias’ within the cost base. Since the business plan submission, we have continued engagement with our regulators on the expansion into the IoS and have already identified specific additional expenditure and requirements
 - **Downstream Thinking** – the full enhancement expenditure has been allocated within the growth categorisation and considered under base modelling. We have provided additional evidence on why this expenditure is enhancement rather than base and outline the activities in this area
 - **Sludge** – we have recognised that a higher proportion of sludge expenditure was assessed within base modelling, however we have included additional evidence supporting an element of spend as enhancement, particularly costs relating to the market requirements
 - **Sewer Pumping Stations** – we have provided additional information and evidence to support the specific enhancement expenditure on sewer pumping stations (which differs from the majority of expenditure which is considered base maintenance) including the permit requirements for flow measurement in relation to the new Environment Agency flow policy and the impact of the new spill frequency measures for permits.
48. In addition to the Isles of Scilly enhancement representations above (total £4.0m for water and wastewater) we are also including representations on £3.9m of base costs adjusted from the overall Isles of Scilly allowances.

49. Overall the total representation for specific enhancement and base totex schemes are:

	Representation £m
Water enhancement	68.7
Wastewater enhancement	20.5
Isles of Scilly base totex	3.9
Total Totex Representation	93.1

Special Totex Claims

50. In addition to the representations on specific enhanced areas of investment we have further considered the base and growth cost modelling within both water and wastewater.
51. Overall the base plus growth totex modelling has resulted in a £57m net increase for water, reflecting South West Water’s continuing efficiency position, and a reduction of £46m in wastewater. In addition, there has been a £20m reduction for the impact of growth modelling on new connections third party reallocations.
52. Following a review of the latest modelling (including the impact of change in approach for growth expenditure) we have identified the following specific claims:

	Totex Representation £m
Water	
Growth expenditure	8.7
Water Totex	8.7
Wastewater	
UV treatment	13.6
Growth expenditure	20.1
Wastewater Totex	33.7
Total Totex Representation	42.4

- **Water Growth Expenditure (including new connections)** – costs associated with new connections had been included within third party services for our business plan submission tables (WS1), however we recognise that these have been included within capital expenditure on the analysis of enhanced expenditure (WS2). We have identified that the updated approach to growth modelling (assuming the new connection costs are reallocated) has resulted in a £20m reduction to South West Water’s totex allowances. We have provided additional evidence to support the efficient cost base and special totex claim in this area
- **UV Treatment** – within our business plan submission we noted that South West Water’s cost of treatment at our wastewater sites was significantly impacted by the high levels of UV facilities at our sites but did not make a cost adjustment claim on the presumption that this would be captured by Ofwat’s modelling. However, it is clear that UV treatment is not accounted for in Ofwat’s latest modelling. South West Water has 63 sites which have UV disinfectant facilities, which is driven by the large number of bathing waters in our region. This equates to 70.8% of our population equivalent having UV treatment, the highest level compared to any other company and we have to operate these throughout the year in contrast to some other companies. These drivers have not been included within the base cost econometric modelling and therefore we have included a special cost factor claim in this area

- **Wastewater Growth Expenditure** – the change in approach to growth modelling has reduced the allowed expenditure by c.£27m within wastewater and we are making specific representations on the relative cost of growth within the South West Water region – particularly linked to the environmental regulations, additional permits and investment needed to support the growth assumptions. We have provided additional evidence to support the efficient cost base and special totex claim in this area.

New additions to the business plan

53. In addition to the representations on specific enhanced areas of investment and base plus growth modelling, we have identified two new areas included within slow-track Draft Determinations. A summary of the cost representations are noted below:

	Representation £m
Southern Water Transfer	5.5
Strategic regional water resource solution	2.3
Total Totex Representation	7.8

- **Southern Water Transfer** – South West Water’s business plan included an expectation that c.20MI/day would be required to be transferred to Southern Water. We have noted that the slow-track Draft Determination includes the transfer of 30MI/day – an increase of 10MI/day. South West Water has considered the impact of this increase and has identified that this would require additional capacity at Knapp Mill water treatment works. Overall the estimated cost of this additional volume is £5.5m, and therefore we are representing on an increase in the costs of Knapp Mill (in addition to the representations made and additional evidence provided on enhancement costs)
- **Strategic Regional Water Resource Solution** – outside of the allowances within the latest view of totex, £1.3m of additional funding has been identified to promote collaboration between water companies to develop regional water resource solutions. We have reviewed the activity and considered the expected costs associated with this (alongside our partners at Wessex Water and Bristol Water) and have identified that the total cost of this for South West Water is expected to be £3.6m. As a result, we are representing on an additional £2.3m. Alongside a summary within our representation we are also submitting a separate joint proposal from the companies within the West Country Resources Group.

For more information see additional information document: Securing Cost Efficiency – supporting information

Delivering Outcomes for Customers

54. In the publication of the slow track company Draft Determinations, Ofwat have made some adjustments to ODIs.
55. We are pleased that on the whole our ODI's in the round remain broadly in line with our Draft Determination following some changes at the Initial Assessment of Plans (IAP) stage with the Early Certainty Principle (ECP) providing some protection in this area.
56. The benefits of protection through the ECP fall outside the P10/P90 range but provides risk mitigation for the three measures where the penalty collar would have been worse under the latest view and removes any financial cap for the enhanced ODIs.
57. This view of our ODI's is based on retaining the internal sewer flooding enhanced outperformance rate, which we represented on at our Draft Determination in April and restate again within this representation.
58. There are some clarifications and observations that we are also making within our representation as follows on:
- Leakage performance commitment rates
 - Priority services register (PSR) reporting guidance
 - Pollutions
 - D-Mex
 - Compliance risk index (CRI).

Internal sewer flooding enhanced rates

59. The intervention proposed by Ofwat at the fast-track Draft Determination stage would remove £1m of potential outperformance per year. We are reiterating our original representation that we consider our proposed internal flooding enhanced rate to be based on customers' views, appropriate and balanced and not an outlier compared to other companies enhanced rates. Furthermore, changes to the ODI incentive rate at this stage seems counter to the ECP to which we have opted in.

Leakage performance commitment rates

60. We have noticed an error in our stated underperformance incentive rates for leakage contained within the South West Water – Outcomes performance commitment appendix issued in April 2019 as part of the fast-track Draft Determination. This is the result of a transposition of rates on a per ML/d basis and % reduction basis.
61. We are restating the correct figures to ensure that at Final Determination the correct rates are used going forward to calculate any underperformance penalties.

	INCORRECT RATES AS STATED IN DD OUTCOME PERFORMANCE COMMITMENT APPENDIX	CORRECTED RATES
Incentive type	Incentive rate (£m/unit)	Incentive rate (£m/ML/d)
Underperformance payment – standard	-0.725	-0.615260
Underperformance payment – enhanced	-1.450	-1.230520

Outperformance payment – standard	0.370	0.370000
Outperformance payment – enhanced	0.740	0.740000

Priority services register reporting guidance

62. We still remain concerned that with the guidance published alongside the Draft Determinations in July, the 90% target for attempted contacts is potentially unachievable given the way the methodology is currently set out.
63. We acknowledge that our initial observations on the methodology have been considered, however with the definition of attempted contact only being limited to proactive contact it means that the target cannot be reached, nor do we believe that this is in the best interest of the customer. To reach the target would mean potential multiple contacts to ‘vulnerable’ customers who have already provided this information. We make a recommendation on how this could be reviewed within the Delivering Outcomes for Customers – supporting information document.

Pollutions

64. We note that with regard to Hafren Dyfrdwy the proposed targets for pollution Incidents reflect the size of their sewer network. In their September 2018 business plan Hafren Dyfrdwy indicated upper quartile performance equates to 1.5 to 2 pollution incidents a year – a target they consider unachievable and unrealistic.
65. Ofwat’s IAP recognises the sewerage system is small and agrees it is not appropriate to set targets on the basis of upper quartile. In making this decision, Ofwat recognises Hafren Dyfrdwy is out of step with other companies, and Performance Commitment Levels (PCLs) need to reflect that.
66. The point we would stress is that this principle is also applicable to other companies. The way that all wastewater networks are maintained and operated reflects their unique characteristics: the size of the operating region (size of geographical area, length of network) the density of connections, the nature of the landscape and number of wastewater treatment works and pumping stations
67. Our current sewer network reflects legacy decisions, i.e. the size of the operating region, the density of connections, and the nature of the landscape has driven investment in the sewer network. The size and structure of our sewer network (e.g. layout, sewer type, sewer diameter, etc) directly reflect these factors.
68. Customers priorities, legislative drivers, and changing weather patterns have also had an important part to play – we have had a strong focus on delivering region-wide environmental improvements and flood reduction programmes over the past 20 years to meet the needs of customers and contribute towards the region’s beautiful environment.
69. With respect to pollution, most of our sewers remain of small diameter – which are more prone to blocking. To that extent, our sewer system is more like the network of Hafren Dyfrdwy, rather than larger companies such as Thames Water or United Utilities.
70. Pollution on the network is best prevented by investing to upgrade/upsized existing sewers, thereby preventing blockages (and collapses). Alongside this, a robust maintenance and sewer strategy is needed to change the operation of the network, proactively diagnose potential issues before they occur, and deal with issues effectively when they arise (before they become categorised as a pollution incident). This is the essence of our plans and operations. But this is not a short-term challenge and this cost is not reflected in the totex assessment.

71. Recognising the importance that our customers and stakeholders continue to place on the environment in the south west, we maintain support for achieving upper quartile pollution PCLs in our business plan, but we consider it important to reiterate that this is an exceptional challenge for South West Water, which we hope our stakeholders and Ofwat recognise.

D-MeX

72. We also note that Ofwat are minded to increase the incentive rates of +2.5% and -5% to +6% and -12% respectively, of annual developer services revenue for D-Mex. Although Ofwat signalled in the March 2019 documents that there is a good case to increase the level of the financial incentive, to reflect the high impact service to developers can have on the wider economy and society, Ofwat also recognise that this is a new mechanism and only after the pilot year, shadow year and a review of the metrics will they gain full confidence in D-Mex.
73. Therefore, we would propose that Ofwat does not include this increase within the Final Determination and sets incentive rates which are more balanced between under/out performance and comparable with other customer metrics.

Compliance Risk Index (CRI)

74. A final observation we make is around the new measure for water quality: the DWI's Compliance Risk Index (CRI).
75. As we noted in our initial Draft Determination response, for drinking water quality it is especially important to get the balance right. A deadband that is too narrow could see many companies penalised during AMP7, which in turn would mean major industry improvements could be branded a failure and potentially erode public trust on the quality and safety of their drinking water.
76. In the July Draft Determinations Ofwat recognised that flexibility is important as it will take time for performance levels to reach 100% compliance for this new measure. It subsequently increased the deadband for the first two years of the period: i.e. the CRI deadband score is 2.0 in the first two years of the period, and 1.5 for the next three years.
77. We support Ofwat's flexible approach adopted in July. However, we are very disappointed that the change in the deadband has not been applied to South West Water performance commitment.

For more information see additional information document: [Delivering Outcomes for Customers – supporting information](#)

Accounting for Past Delivery

SIM Reconciliation

78. We have observed that as part of the July Draft Determination, Ofwat published its SIM reconciliation model and describes for the first time how they will reconcile the SIM mechanism for the 2015-2020 period. This methodology differs to that previously used at PR14 resulting in different under/outperformance incentives being applied from those forecasted by all companies.
79. This results in an overall penalty for South West Water of £4.1m reducing to £3.1m when 2018/19 data will be used to calculate Final Determination. Our forecast was an overall outperformance value of £0.236m (SWW £0.000m /BW £0.236m).
80. We propose that Ofwat continues to apply the methodology first established at PR14 for calculating under and outperformance incentives due to companies under SIM, which is also the approach Ofwat will apply to calculating the C-MeX incentive rate in each year. It seems inconsistent to change the methodology for the SIM reconciliation and then return to the C-Mex methodology which is similar to the PR14 methodology.

For more information see additional information document: Accounting for Past Delivery – supporting information

Other considerations

Bio-Resources - inviting stakeholder opinion

81. We note in your Securing Cost Efficiency Technical Appendix that you are considering applying separate catch-up efficiency challenges to each of the wholesale wastewater controls and also considering using bioresources models alone to set the bioresources controls.
82. Whilst it is difficult to understand the impacts of such a change, given the nuances of the modelling and without models being run, we would be happy to engage in this discussion once more information is available ahead of Final Determinations.
83. Our initial thoughts are that separating the models could exacerbate any biases around scale and rurality which can already impact wastewater modelling, to which South West Water is particularly exposed. The combination of topography and sparsity, low economic transport distances and no very large population centres, which can support large Sludge Treatment Centres (STCs), leads to a large number of small STCs spread out across the South West.
84. These relatively small STCs have higher unit operating costs than larger versions and are not of a scale that can support economically viable advanced energy recovery with the current technologies (preventing access to significant operating cost reduction opportunities). Where it has been economic to do so we have invested in conventional Anaerobic Digestion and energy recovery, but this only covers 23% of our raw sludge production so we have a relatively low capital investment, high operating cost asset configuration. Conversely, the potential advantageous factor of a rural location in terms of proximity to landbank do not materialise due to the coastal location of our larger populations (and so larger WWTWs and STCs) which, combined with the peninsular effect, necessitate significant transport to STCs and back out to agricultural land.
85. We have found that measures of sparsity have a positive (operationally intuitive) sign and test statistically significant in our models. This tallies with our operational view that sparsity is the key factor driving unit cost differences in wastewater services and is likely to be so in Bioresources, and as such we would want to ensure that any proposed changes did not disadvantage our cost assessment unfairly for Final Determinations.

Developer Services – list of excluded charges for the purposes of Condition B

86. In the latest Draft Determination, within 'Ofwat proposed approach to regulating developer services appendix', Ofwat state that to give effect to the proposal relating to diversions, Ofwat are consulting on whether the list of Excluded Charges for the purposes of Condition B should include amounts payable in relation to diversions other than those required by section 185 of the Water Industry Act 1991. Ofwat are asking that each water company indicate whether or not they would be prepared to agree to this and whether they have any comments on the following proposed definition:

'In relation to the period from 1 April 2020 to 31 March 2025, amounts payable in relation to the alteration or removal of any relevant pipe (as defined in section 158 of the Water Industry Act 1991) or other apparatus that the Appointee is required to carry out under the New Roads and Streets Works Act 1991 or any other statutory provision except section 185 of the Water Industry Act 1991.'
87. South Water Water can in principle agree to the licence change subject to understanding how it will interact with any true-up mechanism for developer services either at the end or within the regulatory period.

Conclusion

88. To conclude, we limited our Draft Determination representation in April on the presumption that as a fast-track company there would be minimal changes through to Final Determination. It is also clear that there may yet be further adjustments ahead of Final Determination.
89. However, the Draft Determinations for slow-track and significant scrutiny companies which were issued in July included aspects that have had a significant impact on South West Water's business plan.
90. We thought very carefully about how to respond to the July Draft Determination for slow-track companies and we believe our updated representations are in our customers' best interest to ensure that the company can continue to maintain and improve the services to customers in the areas that matter most.
91. We welcome the opportunity to present and discuss further our representation with Ofwat in October or responding to queries in advance of our meeting to ensure a positive outcome for our customers who unequivocally demonstrated a high level of support for the balance of service, investment and bills in our business plan.



South West
Water



Bournemouth
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