Response to Draft Determination

PAYG

Issue

Throughout the development of our business plan, we have made full use of the regulatory flexibility provided under the total expenditure regime to keep bills affordable for customers. Both our December plan, and June submission update, included material reductions in our RCV run-off rates (compared to AMP5). This ‘slowing’ of RCV depreciation enabled us to protect our customers from bill increases in excess of inflation.

After taking into account all of the representations we are making on the Draft Determination, our plan revenues are around £25m less over the plan period than in our June submission update, at the Appointee level.

Any unmitigated reduction in plan revenues weakens our funds from operations, a key measure in assessing financeability. As mitigation, we therefore propose to amend our PAYG rates to align operational cash flows. The scale of adjustment will not in anyway undermine the affordability of our plan. Indeed customer bills will increase by less than we indicated in our June submission update.

Remedy

- To mitigate the c£25 million reduction in Appointee revenues (compared to our June submission update) we propose to increase our PAYG rate (for both Water and Sewerage by 0.25% (to 51.43% Water and 46.41% Sewerage).

- This adjustment equates to a 0.01% increase to PAYG rates (both Water and Sewerage) for every £1m decrease in Appointee revenues against our June Plan.

Our representation titled ‘financeability and cost of capital’ concludes that we believe the outcome of our representations to be financeable.

We would further propose that the 0.01% increase in PAYG for every £1 decrease in Appointee revenues “scaling factor” should be applied by Ofwat in response to any incremental change to plan revenues as a result of the Final Determination. We would note that this will not automatically result in Southern Water concluding that our plan remains financeable plan – as any departure from our representation position will need to be viewed in the round, when assessing financeability.
Summary of the evidence

Throughout the development of our business plan, we have made full use of the regulatory flexibility provided under the total expenditure regime to keep bills affordable for customers. Both our December plan, and June submission update, included material reductions in our RCV run-off rates (compared to AMP5). This ‘slowing’ of RCV depreciation enabled us to protect our customers from bill increases in excess of inflation.

In our December submission, we slowed the RCV run-off rate on average across the water and wastewater services from 6.3% of RCV to 5.3% of RCV. As a result our average household Bill was projected to increase by 0.6% less than inflation. Without our intervention to reduce the pace of RCV run-off average customer bills would have increase by 5.5% more than inflation between 2015 to 2020.

In response to Ofwat’s risk based review guidance and the reduction in the WACC, our June submission update saw a slight increase in our RCV run-off rate from 5.3% to 5.6% in order to maintain an appropriate balance between affordability and financeability.

As the chart below shows, despite the marginal increase in RCV run-off rates between our December plan and June submission update, customer bills are still 3.9% lower than they would otherwise have been had we left the rate of RCV run-off at current AMP5 levels.

Note: Ofwat have published average household bill movement as the percentage movement from the average household bill for 2014/15 and the average household bill for 2019/20. This results in a real reduction in average household bills in our June Plan of 3.2% versus the 1.5% movement calculated with reference to the average movement in average household bills over the PR14 (AMP6) period.

Our proposed change to PAYG rates in our representation continues to underpin a plan that is strongly supported by our customers as being affordable whilst going some way to recognise the need to mitigate revenue reductions by increasing funds from operations.
Our proposed PAYG adjustment equates to a 0.01% increase to PAYG rates (both Water and Sewerage) for every £1m decrease in Appointee revenues against our June Plan. We further propose that that the 0.01% increase in PAYG for every £1 decrease in Appointee revenues “scaling factor” should be applied by Ofwat in response to any incremental change to plan revenues as a result of the Final Determination.

We would note that this will not automatically result in Southern Water concluding that our plan remains financeable plan – as any departure from our representation position will need to be viewed in the round, when assessing financeability.

For illustration: The outcome of our representation would reduce our Appointee revenues by £25m, and we would propose to increase our PAYG rate (for both Water and Sewerage by 0.25% (to 51.43% Water and 46.41% Sewerage).

The increase to PAYG, combined with the reduction in revenues, will not increase bills, but will reduce the overall reduction in Appointee revenues to £18m (i.e. recover £7m via an increase to our PAYG). The consequence of the combined effect of the revenue reduction and the adjustment to our PAYG rates is that average household bills which increased by 3.2% less than inflation under our June submission update will now increase by around 3.6% less than inflation post our representations (based on movement between opening and closing bill).

Impact on financeability:

We have not for this representation included an illustration of financeability changes, because the totality of the Draft Determination changes from our June Plan, despite being material, have been disregarded for the notional company financeability assessment.

Table 1. Notional financeability ratios. Draft Determination vs June Plan

<table>
<thead>
<tr>
<th></th>
<th>Cash Interest Cover</th>
<th>ACICR</th>
<th>FFO/Debt</th>
<th>PAYG (water/waste)</th>
<th>RCV Run-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Southern – DD</td>
<td>3.4x</td>
<td>1.5x</td>
<td>11.3%</td>
<td>51.2% / 46.2%</td>
<td>4.2% / 5.8%</td>
</tr>
<tr>
<td>Southern - June</td>
<td>3.4x</td>
<td>1.5x</td>
<td>11.4%</td>
<td>51.2% / 46.2%</td>
<td>4.2% / 5.8%</td>
</tr>
</tbody>
</table>

- Legacy items such as the RCM, OIA, SIM, and CIS are excluded from the calculation of notional ratios. This treatment is in line with historic practice, and our expectation, but nonetheless disregards any movement between plans.

- Notional ratios are calculated assuming that all Totex and Retail challenge is met in full, without sufficient regard to the pace of change an efficient company may be expected to deliver.

- The Serviceability penalty has been deducted from RCV in advance of the notional gearing adjustment. We do not agree with this treatment as it disregards the effect of this adjustment on both closing AMP5 gearing and opening AMP6 gearing, and gives no consideration as to how this change in RCV is expected to be accommodated.
3. Board Engagement

The Board support and stand behind the position set out in the representation.

4. CCG

We have discussed our approach to managing affordability with the CCG, including how we have used the regulatory tools available throughout our PR14 planning process of our December Plan and the June Plan (including the January risk and reward WACC guidance from Ofwat).

A separate report by the CCG confirms support for our management of affordability.

5. External Assurance

Tables S10 and W10 (PAYG rates) will be submitted to Ofwat as part of this representation. Table content will be checked by Deloitte to underlying calculations and the values expressed in this representation.