Response to Draft Determination

Financeability and Cost of Capital

Issue

The Board are concerned that the scale of challenge between Southern Water’s June plan and Ofwat’s Draft Determination (the Draft Determination) is not reflected in our notional financial ratios.

In particular, the Board considers that the totality of the challenge covered by our representations on the Draft Determination, if unchanged in the Final Determination, would go well beyond an appropriate level of efficiency challenge and would result in efficient expenditure not being funded.

The Board considers that this potential underfunding, which is not reflected in our notional financial ratios, leads to:

i. an overstatement of our notional financial ratios;
ii. an understatement of the balance of risk with respect to delivery; and
iii. would prevent Southern Water from earning the allowed cost of capital.

The Board considers that Southern Water’s plan is financeable if its representations are taken account of by Ofwat in the Final Determination. However, in the absence of material movement in the Final Determination, the Board would need to revisit their position on the financeability of our plan. In particular, whilst we understand the calculation and inputs for both the notional financial ratios and cost of capital, there have been significant interventions with respect to ODIs, serviceability, and financeability. Unchanged, these interventions do not appear commensurate with the level of risk within the allowed return.

Remedy

We would expect Ofwat to reflect our representations in the Final Determination
Summary of the evidence

1. Evidence

(i) Overstatement of Southern Water’s notional financial ratios

Between our June submission and the Draft Determination there has been significant challenge, including:

- Water toex models amounting to £45m
- Sewerage toex models amounting to £56m
- Serviceability shortfall amounting to £153m
- Average cost to serve amounting to £43m

Table 1, Projected notional financial ratios: June versus Draft Determination (Ofwat), below, illustrates that despite making interventions totalling £297m, our notional financial ratios between June and the Draft Determination have barely changed. Due to their construction the notional financial ratios therefore assume that our cost and capital structures can accommodate these interventions overnight which, given their size, is clearly unrealistic.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj ICR (x) – June plan</td>
<td>1.60</td>
<td>1.54</td>
<td>1.53</td>
<td>1.50</td>
<td>1.47</td>
<td>1.47</td>
</tr>
<tr>
<td>Adj ICR (x) – DD</td>
<td>1.60</td>
<td>1.54</td>
<td>1.51</td>
<td>1.49</td>
<td>1.46</td>
<td>1.46</td>
</tr>
<tr>
<td>FFO/debt (%) – June plan</td>
<td>11.0</td>
<td>11.7</td>
<td>11.5</td>
<td>11.3</td>
<td>11.2</td>
<td>11.3</td>
</tr>
<tr>
<td>FFO/debt (%) - DD</td>
<td>11.0</td>
<td>11.7</td>
<td>11.4</td>
<td>11.3</td>
<td>11.2</td>
<td>11.2</td>
</tr>
</tbody>
</table>

(ii) Understatement of risk with respect to delivery

We have always highlighted that we consider financeability to be one dimension of the wider balance of risk and reward in our plan. In particular, we have been clear in our priority to provide affordable bills to customers in preference to headroom against our target notional credit rating of A3. This can be seen from Table 1 above, where our target notional financial ratios are generally very close to, or in some cases lower than, the relevant thresholds. These thresholds, as explained in our June plan, represent what our Board would consider to be notional financial ratios commensurate with our desired credit rating.

Our June submission update, excluding legacy adjustments, proposed allowed revenues that were approximately 17% lower on average than AMP5. It is in this context, having included £189m of efficiency in our June plan, that we believe the Draft Determination interventions listed below should be included in our notional financial ratios if they are not reversed in light of our representations, as we consider them to be over and above a reasonable efficiency challenge.
We would consider our notional financial ratios on the basis of the Draft Determination to be as set out below in, Table 2, Projected notional financial ratios:

June plan versus Draft Determination (Southern Water calculation):

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj ICR (x) – June plan</td>
<td>1.60</td>
<td>1.54</td>
<td>1.53</td>
<td>1.50</td>
<td>1.47</td>
<td>1.47</td>
</tr>
<tr>
<td>Adj ICR (x) – DD</td>
<td>1.60</td>
<td>1.32</td>
<td>1.31</td>
<td>1.29</td>
<td>1.26</td>
<td>1.24</td>
</tr>
<tr>
<td>FFO/debt (%) – June plan</td>
<td>11.0</td>
<td>11.7</td>
<td>11.5</td>
<td>11.3</td>
<td>11.2</td>
<td>11.3</td>
</tr>
<tr>
<td>FFO/debt (%) - DD</td>
<td>11.0</td>
<td>10.44</td>
<td>10.32</td>
<td>10.18</td>
<td>10.04</td>
<td>10.03</td>
</tr>
</tbody>
</table>

The above ratios reflect the following interventions being reflected in our expenditure:

- Serviceability shortfall applied after opening balance sheet set to 62.5% net debt to RCV;
- Water and Sewerage totex challenges taken as our implied menu choice; and
- £23.8m of the retail ACTS gap relating to our specific representations deemed to be in excess of an efficiency glide path.

Once these adjustments are applied, we would consider the resulting notional financial ratios to be inconsistent with our notional target credit rating of A3 as they are significantly below the required thresholds.

Expenditure related to our base year, input price pressure, and bad debt all lead to a substantial reduction in our recovered retail margin. In fact, based on these retail margins we would not consider the HH retail price control to be financeable.

Table 3, Household Retail Margin: Southern Water Draft Determination including £23.8m of expenditure that we are representing on:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Margin – Allowed (%)</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Retail Margin – Actual (%)</td>
<td>0.32</td>
<td>0.34</td>
<td>0.37</td>
<td>0.39</td>
<td>0.41</td>
</tr>
</tbody>
</table>

At the appointed business level, the Draft Determination would imply a base return on regulated equity of 4.40% on average versus 5.65% allowed for the appointed business.

Understandably, these returns would not be considered acceptable by our Board and investors. It is worth highlighting that, due to a significant revenue shortfall in the prior period, we have been unable to achieve the allowed cost of capital over the 5 years of AMP5, whilst this will now be recovered it has caused considerable difficulties with both credit ratings and returns in the meantime.

Of critical importance to our Board and investors is that we secure a Final Determination that can deliver our most important priority of affordability for our customers alongside an acceptable level of return.
Southern Water’s allowed cost of capital

Further, in moving to an outcomes based regulatory regime we understood that there would be triangulation between base returns as provided via the WACC, penalties and rewards through Outcome Delivery Incentives (ODIs), and outperformance opportunities against the totex incentive.

Following the outcome of the Draft Determination, we do not consider this approach provides an acceptable level of risk and return. As an example, our ODIs whilst always stretching have been adjusted to the extent that they are asymmetrical with respect to downside, and the totex efficiency has been set at upper quartile with significant challenges with respect to scope. This is a significantly harsher package as compared to PR09 with a significantly lower WACC. As an example, we proposed a symmetrical ODI with respect to “per capita consumption” that was driven by customer research, as opposed to statutory or regulatory obligations, that has been changed to penalty only.

We do not consider this to be in the best interests of customers. Such a harsh regime could stifle innovation and impact the resilience of the industry to unforeseen events and longer term trends such as climate change. We share Ofwat’s view that companies should be encouraged to improve service levels for their customers and lower costs, however, a regime where companies are subject to upper quartile efficiency challenges through both totex and ODIs poses asymmetrical delivery challenges that will ultimately be borne by equity.

In addition, whilst we do not accept the proposed serviceability shortfalls in the Draft Determination, we do not consider the proposed RCV reduction to be in line with best regulatory practice, that is to say, any significant ex post adjustment to RCV should be fair, well-reasoned, proportionate and clear and understood. The consequences of the scale and retrospective nature of the RCV adjustments would be that investors require a much higher equity return where a regulator is prepared to claw back significant amounts of invested capital several years after the fact.

In conclusion, the Board continues to support the financeability of Southern Water’s plan on the assumption that our specific representations are taken account of in Ofwat’s Final Determination.

Without material movement in respect of our specific representations for Ofwat’s Final Determination, the Board would need to re-evaluate the potential returns to Southern Water’s investors and the notional financeability position.

2. Board Engagement

The Board have been engaged with respect to our financeability position through weekly calls, working sessions, and one to one meetings.

3. External Assurance

We do not consider our financeability position to need external assurance.