

Chapter SRN10

Risk and Return

10. Risk and Return

10.1. Introduction

Our PR24 plan delivers for all of our stakeholders and the environment, providing a fair and appropriate balance of risk and return. This balance is essential for ensuring that we deliver the service customers have told us they want, the environmental improvements we need to make are delivered, bills are acceptable to customers and our investors receive a fair return commensurate to the level of risk taken.

The financial resilience of the company is improving, supported by equity injections into the group from our shareholders amounting to £1.65 billion in the current investment period. This provides a solid foundation for our operations and performance improvement through the [Turnaround Plan](#) and ensures that we can accelerate performance to meet the demands of our 2025–30 plan

- In this five-year period we have already invested £1.174 billion more than our regulatory allowance as part of our commitment to ongoing transformation. The company has not paid dividends to external shareholders since 2017
- Over £400 million of allowed returns, in the PR24 period, will be retained in the company to support the planned investments
- Our track record showcases our dedication to delivering long-term value for our customers
- Key elements of our Water Industry National Environment Plan will need to be delivered over an eight-year period, rather than five. To help secure the plan we will use a number of alternative delivery strategies over the period and other methods of finance

Our plan targets an improvement to our credit rating with a rating of BBB+/ Baa1. This will allow the company to maintain a strong funding platform for future investment. Over AMP8 we are projecting to raise £4.6bn of debt, of which £1.2bn is refinancing of existing debt and £3.4bn will be new. We will continue to manage our capital structure so that our gearing is around 70% but will not exceed 75% for the duration of AMP8. The combination of improved credit ratings, a strong growth in RCV in an environmental driven programme and the delivery of our [Turnaround Plan](#), gives us confidence we can continue to raise financing at competitive rates.

We have recalculated the implied risk in the price control methodology. Our analysis has found that the risk to the notional company is in excess of that implied by Ofwat's Weighted Average Cost of Capital (WACC) analysis, as well as being skewed to the downside. We are concerned about the level of risk exposure. In the interests of customers we are suggesting in this Business Plan how the risk, for the notional company, could be mitigated with some alternative and innovative proposals which we would like to discuss further with Ofwat.

Further, we note that there are a series of uncertainties about AMP8 at the time of writing this plan. These reflect decisions that require further discussion with our regulators. We want to work with our regulators during the PR24 review period to resolve as many of these uncertainties as possible. There are also a number of cost items which will remain uncertain into AMP8. For both sets of uncertainty, we propose mechanisms that Ofwat could use in its decision for dealing with the uncertainty.

Given the remaining risk in our plan, we have worked with [REDACTED] to understand a reasonable return for investment. In this section, we summarise the Southern Water WACC calculation appropriate for us, which is based on an updated [REDACTED] methodology. Although our plan uses a cost of capital based on Ofwat's Final Methodology for convenience, it is essential that our representations on the calculation of the Southern Water cost of capital are accepted by Ofwat to rebalance the risk. We note further that the asymmetry premium within our calculation of the cost of equity could be reduced if Ofwat agrees to rebalancing of the risk beyond that we have proposed.

Our plan is financeable on both the notional company structure, which Ofwat will consider in its assessment, and the actual company structure, which the company and its Board has used in its assessment of the plan and will be the basis on which the business is financed. This assessment of financeability for the notional company is based on the Ofwat WACC. The actual company financeability has been assessed both using this updated Ofwat WACC, so that we are compliant in adopting Ofwat's recommended approach; and also the Southern Water WACC. Our assessment of financeability is contingent on the risk for the notional company being mitigated and the uncertainty mechanisms included in this plan being adopted.

Finally, this chapter provides an outline of our dividend (section 10.6) and executive pay policies (section 10.7).

Further detail on these areas is available in our technical annexes.

10.2. Mitigating the level of risk in Ofwat's methodology

10.2.1. Introduction

The water sector's risk landscape is changing significantly in AMP8, driven by an unprecedented step-change in the scale of required investment, heightened macroeconomic volatility and interest rate increases, a downside asymmetrical regulatory incentive package, challenges associated with net zero, population growth and finally, greater frequency of severe weather events.

At the same time, given the increasing investment, there is a growing need for the sector to attract new equity capital, which will be contingent on an alignment between allowed returns and forward-looking risk exposure. These challenges are at the heart of our risk analysis which targets to capture the impact of the changing risk landscape on potential variations in outturn equity return versus the allowed level.

10.2.2. Unmitigated RoRE assessment (summarised)

Our risk analysis is based on the Monte-Carlo simulations that yield probability distributions of expected performance on each risk parameter, informed by the sector's standard deviation, and median. The starting point of the notional company RoRE ranges is the sector's historical performance in the first three years of AMP7 price control, given its similarity to AMP8 incentive regime and hence relevance for predicting future performance. The notional company RoRE ranges have also been refined to ensure they capture the changing risk landscape by incorporating the evolution of risk associated with:

- Larger and more complex enhancement programme driven by the statutory requirements and application of Price Control Deliverables (PCDs) to most of the enhancement spend which increase the downside risk

- Risks to the notional company from projects delivered under Direct Procurement for Customers (DPC) and alternative delivery routes
- Energy price increases surpassing inflation and associated high volatility, which is not reflected in the Real Price Effects (RPEs)
- Stretching performance targets, accompanied by the removal of most ODI caps, deadbands and collars, inherent asymmetry embedded in penalty-only ODIs, and not allowing exclusions related to the impact of severe weather events
- Increase in the level of interest rates and high macroeconomic volatility affecting financing risk
- Continued use of asymmetric cost sharing rates, and the increased risk exposure due to larger revenue at risk.

As the relationship between different components of risk is complex, correlation analysis has been undertaken for ODIs as it cannot be assumed that the performance commitment risks are fully additive.

Risk analysis resulted in the notional company's RoRE exposure of -9.94% (P10, worst case scenarios) to +2.56% (P90, best case scenario), with expected risk to returns of -3.59% (P50, most likely scenario). This is significantly wider and asymmetrical to the downside than the illustrative ranges presented in Ofwat's PR24 final methodology, and so the overall package of incentives is unlikely to allow the notional company a reasonable opportunity to achieve the base allowed return. Moreover, nominal risk-adjusted equity return would be below the nominal cost of debt allowance, negating the notional firm's ability to attract new equity.

Table 1: The notional company RoRE ranges (before mitigation) – Southern Water's analysis

	RoRE range	Ofwat's notional company RoRE range	Difference
Upside (P90)	2.56%	4.80%	-2.24%
Most likely (P50)	-3.59%	0.00%	-3.59%
Downside (P10)	-9.94%	-4.95%	-4.99%

Major drivers of risk asymmetry are totex, ODIs and retail, with the downside exceeding the upside several fold and respective P50 RoRE in the negative territory at -2.18%, -0.88% and -0.29% respectively.

Totex ranges are asymmetric due to significantly greater proportion and scale of enhancement spend which has a fundamentally different risk profile to that of base spend, exacerbated by the introduction of PCDs and the risk that totex allowance can be clawed back when part but not all deliverables are achieved.

Additionally, the range also reflects underperformance against AMP7 base cost allowances by the sector on average driven by the energy cost increases surpassing general price inflation. The magnitude of the totex RoRE impact is driven by the sheer scale of the enhancement programme for a notional company which is more than two times larger in AMP8 than it was in AMP7, reflecting the scale of investment faced by a company operating in the South-East of England.

The asymmetry in the ODI RoRE range stems from the presence of penalty only ODIs such as Compliance Risk Index (CRI) and Discharge Compliance, where Discharge Compliance will no longer benefit from a deadband while the deadband for CRI will become narrower and confined to failures caused by customers' internal fittings.

The incentive regime on other ODIs is also becoming more punitive, including supply interruptions and pollution incidents. While the sector is benefitting from a collar on supply interruptions in AMP7, our unmitigated notional company risk analysis assumes that the collar that applies in AMP8 is much wider, exposing companies to potentially very significant downside from one-off but severe events.

Similarly, the downside on pollution incidents is increasing because pollutions occurring due to named storms will no longer be excluded from the penalties. Per capita consumption is another area of asymmetry where companies have limited ability to influence customer behaviour, as was evidenced by sector-wide underperformance in AMP7 due to a shift in customer consumption patterns during and after Covid-19.

Retail RoRE ranges reflect sector underperformance in AMP7, which on average amounted to -0.60% in terms of return on notional equity.

In addition to the overall RoRE range being asymmetrical to the downside, it is also wider than estimated by Ofwat, with financing risk, DPC and alternative delivery adding more volatility to both upside and downside of the overall risk exposure.

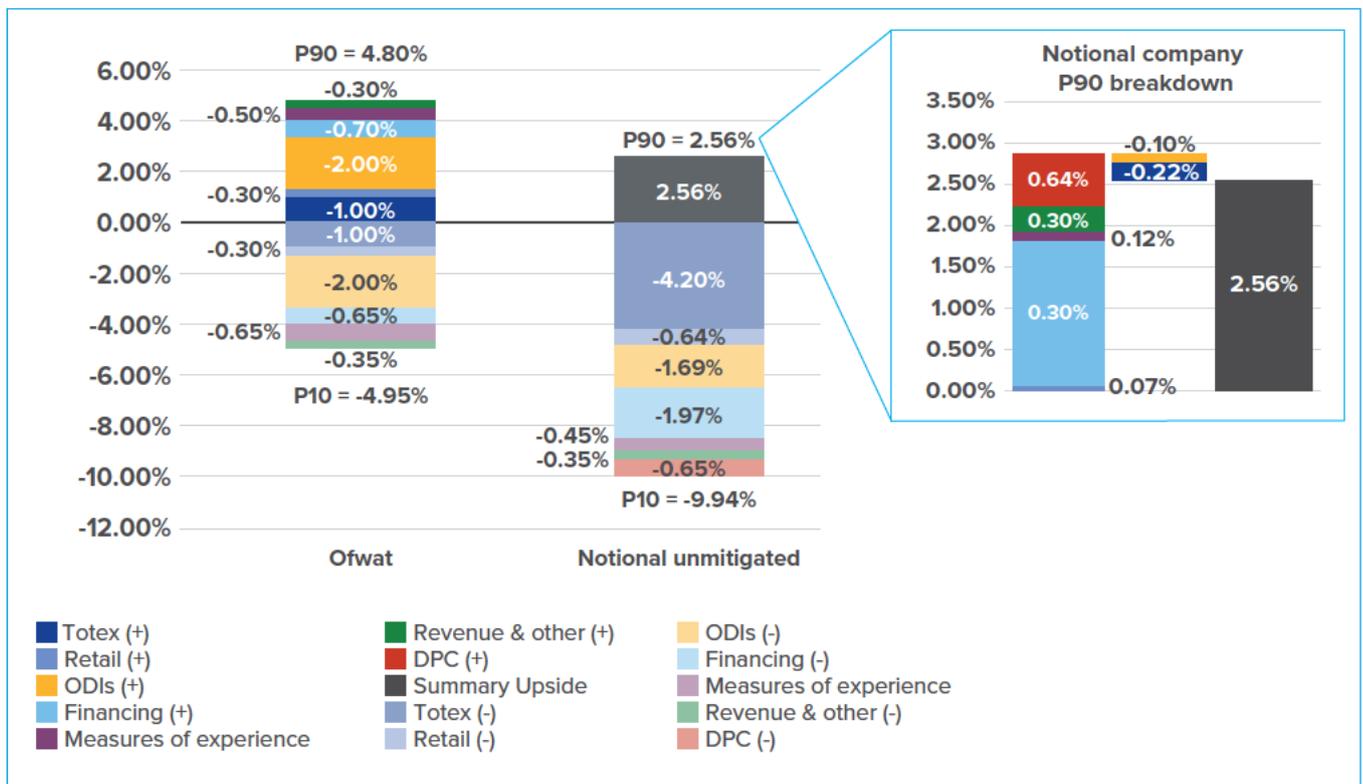


Figure 1: Drivers of the notional company RoRE ranges: Southern Water's analysis versus Ofwat's analysis
Source: Southern Water analysis



As stated by Ofwat, a balanced package of incentives should allow the notional company to have a reasonable prospect of achieving a base allowed return. However, our risk analysis has identified that the notional company will only have a reasonable prospect of achieving a return that is 3.59% below allowed return, given the myriad of risks it is exposed to and asymmetry of incentives. Moreover, the notional company risk exposure is inconsistent with Capital Asset Pricing Model (CAPM) principle that returns are clustered around the mean with a symmetric distribution and instead suggests that the incentive package introduces asymmetry that requires an adjustment to CAPM-derived cost of equity. Absent such an adjustment, the risk and return proposition in PR24 is imbalanced, could cause financeability and deliverability issues and would not attract equity capital required to fund investments.

From this analysis we conclude that the notional company is subject to an excessive downside risk asymmetry resulting in it being unable to earn the allowed cost of capital on a mean expected basis. Adjustments are therefore required to the balance of risk and return.

10.2.3. Proposed mitigations

Ofwat noted that it would seek to address any perceived asymmetry within the balance of incentives because it considered this preferable to adjusting allowed returns. It also remarked that it would seek to limit the exposure of companies to risks they cannot effectively manage or control. To address the notional company risk asymmetry, we followed Ofwat's principles and developed a range of risk mitigations that would target the problem at source.

As an example of a suite of risk mitigations, we propose the following changes to the PR24 incentive package. This particular package represents one of many possible combinations of risk mitigating measures. It serves as an example of the sheer degree of mitigations required to balance out the risk inherent in the PR24 FM package. Both financeability and financial resilience of the notional company greatly depend on its ability, under the base case scenario, to earn the allowed return. Absence or insufficiency of the risk mitigations would, therefore, render the notional company not financeable.

Table 2: Notional company risk mitigations

Area of risk mitigation	Mitigations applied to notional company
ODIs	<p>1. ODI rates</p> <ul style="list-style-type: none"> Reduction in ODI rates on total pollutions based on sector's performance in AMP7 to £0.4 million from £0.9 million (scaled to 0.5% of FY23 wastewater regulated equity), 44% of Ofwat's original rate Reduction in ODI rate for supply interruptions to £0.13 million from £0.68 million based on sector's performance in AMP7 (scaled to 0.6% of FY23 water regulated equity), 18% of Ofwat's original rate Reduction in ODI rates for PCC and Business demand (scaled to c. 0.5% of water regulated equity) to £0.18 million and £0.07 million, respectively, 20% of Ofwat's original rate. PCC and Business Demand are mostly outside of companies' control so companies are not best placed to manage the associated risk, and a reduced strength of an incentive would be appropriate <p>2. Individual caps and collars</p> <ul style="list-style-type: none"> Collar on Water supply interruptions (at 52-64 normalised duration in mins) – 0.5% water regulated equity Collar on External sewer flooding (at 17-20 normalised incidents) – 0.5% wastewater regulated equity Caps and Collars on the newly introduced common ODIs (Bathing water quality, Storm overflows, River water quality, Serious pollution incidents, Business demand) and other asset health ODIs (Mains repairs and Unplanned outages) <p>3. Deadbands</p> <ul style="list-style-type: none"> Introduction of deadbands on CRI (of 3.3), Discharge permit compliance (of 98.2%) and Serious pollution incidents (of 1.0)
Totex	<ul style="list-style-type: none"> Reduced impact of Price Control Deliverables (PCDs): coverage down to 27% from 90% of total enhancement spend Limited use of PCDs in relation to enhancement schemes that form legislative requirement or fund performance improvement as it would result in a duplication of penalty Grouping PCDs for the larger categories of enhancement spend to allow for offsetting / diversification impact within those groups Implementation of RPEs for power costs Asymmetric sharing rate for enhancement totex: the notional company bears 0% of underperformance risk but benefits from the 50% outperformance Removal of the negative adjustment to WACC related to retail margin as it unwarranted based on the sector's actual performance in AMP7
Return Adjustment Mechanisms (RAMs)	<ul style="list-style-type: none"> Introduction of Return Adjustment Mechanisms (RAMs) that would replace Aggregate ODI sharing mechanism and cover all the risk related to operational performance, including ODIs, Totex, DPC/alternative delivery, retail and measures of experience RAMs are being applied by Ofgem in its RIIO-2 price controls across gas and electricity networks with sharing 50% of out/(under) performance when RoRE reaches +/- 3.00% and 90% of out/(under) performance when RoRE reaches +/- 4.00%

Alongside the ODI and totex mitigations, we are also proposing to extend the current aggregate ODI sharing mechanism to cover all areas of operational performance, similar to the RAMs applied by Ofgem, given the very material downside risk that a notional company is exposed to by the virtue of the overall incentive package.

The purpose of RAMs would be to provide protection to consumers and investors if a water company return is significantly higher or lower than anticipated at the time of setting the price control. Consumers and investors will benefit from the introduction of RAMs as they would be protected against the possibility of unreasonably high or low returns in the AMP8 price control. RAMs will also help to ensure the fairness of AMP8 by protecting consumers and investors against ex post overall returns deviating greatly from ex ante expectations and would significantly improve a case for new equity.

We suggest that, similar to the precedent, RAMs should:

- Be symmetrical, providing for adjustments both due under and outperformance as this represents a fair balancing of the interests of consumers and investors
- Account for any trade-offs between Totex and ODI performance
- Exclude financial performance as that would cause customers bear the risk associated with actual capital structures

- Exclude QAA performance to preserve the value of the business plan incentive
- Serve as an end of period true-up, implemented as a part of the close-out of AMP8, with a sharing rate of 50% of out/(under) performance when RoRE reaches +/- 3.00% and 90% of out/(under) performance when RoRE reaches +/- 4.00%.

RAMs would align the interests of companies and investors with those of customers, so that the sector remains attractive to investors, with both customers and investors being protected against the extremes.

10.2.4. Mitigated RoRE assessment (summarised)

This proposed suite of mitigations is one of the possible combinations that is targeted to mitigate risk at source. Each category of mitigations brings the notional company’s RORE risk range closer to Ofwat’s expectations of the notional company’s RoRE risk range: totex mitigations and RAMs increase the upside and decrease the downside due to the application of fewer PCDs and asymmetric sharing rates on enhancement totex, while ODI mitigations just reduce the downside. Figure 2 presents the degree of impact of each group of mitigations on the notional company’s P10 and P90 risk ranges.

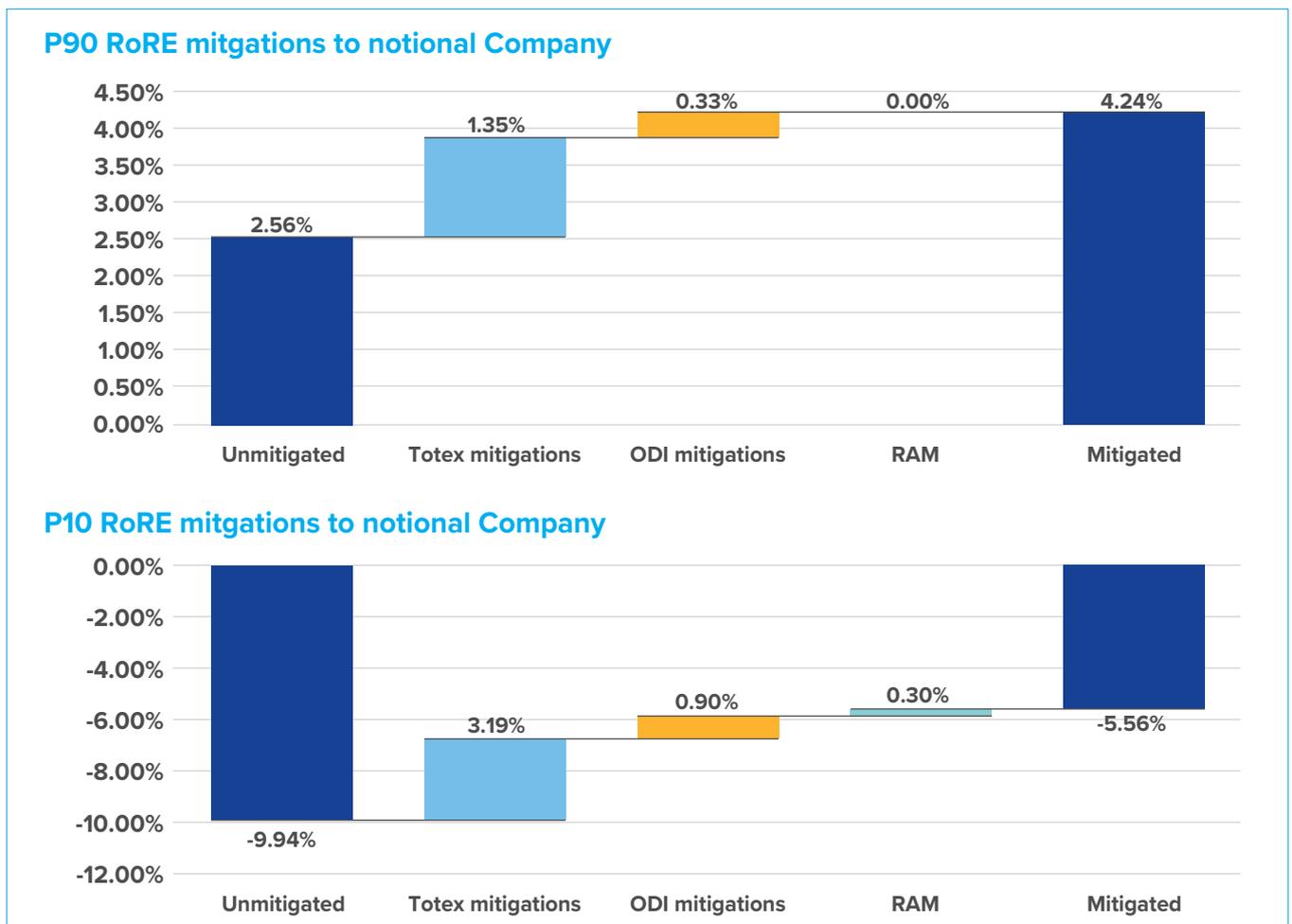


Figure 2: Relative contribution of risk mitigation to the reduction of risk exposure

On a mitigated basis, the notional company ranges become more narrow and less asymmetric, but some asymmetry remains, with P50 at -0.84% and hence the mean-expected return still below allowed equity return. This residual asymmetry is distributed between totex, ODIs, retail and C-Mex and could be eliminated at source by setting more realistic performance commitment targets recognising the notional company's starting point or increasing wholesale and retail totex allowances. It could also be addressed by appropriately adjusting the cost of capital allowance if no other changes to the incentive package occur.

Similar to the notional company, we also propose a suite of risk mitigations as part of our PR24 submission, which, in addition to the notional company's mitigations also includes different ODI targets, with a glide path to improve our performance towards the end of AMP8. Our board assurance statements on financeability and financial resilience are predicated on these risk mitigations being accepted by Ofwat.

Table 3: Notional and actual company RoRE ranges (after mitigation) – Southern Water's analysis

	Ofwat's notional company RoRE range	Notional company mitigated RoRE range	Actual company mitigated RoRE range
Upside (P90)	4.80%	4.24%	0.88%
Most likely (P50)	0.00%	-0.84%	-4.46%
Downside (P10)	-4.95%	-5.56%	-8.19%

As a company in turnaround, mitigated RoRE ranges are even more asymmetric for us, with the mean risk-adjusted return close to zero, as cost of equity allowance is offset by the remaining risk at P50. While we are working hard to ensure that we deliver on our [Turnaround Plan](#), it is important that we are not exposed to unlimited amounts of risk. An unmitigated risk exposure would place an immense financing challenge on us.

If our return is not commensurate with the level of risk in the plan, we may not be able to secure the needed capital to fund the [Turnaround Plan](#) and improve the level of service we provide to our customers. Proposed risk mitigations are, therefore, in the best interest of customers, as they would help us secure appropriate funding to improve our performance.



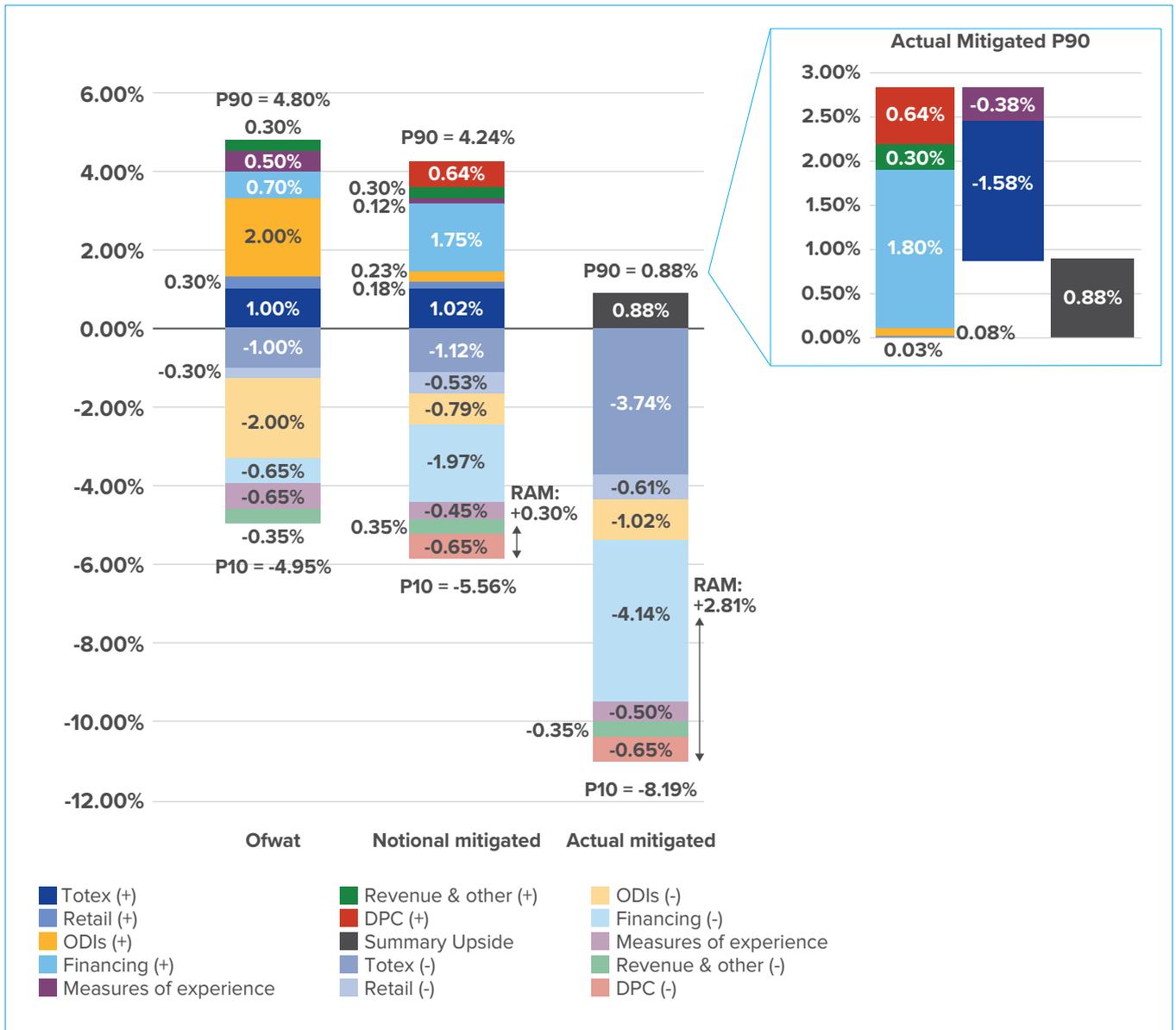


Figure 3: Drivers of the mitigated RoRE ranges: Southern Water’s notional and actual company analysis versus Ofwat’s analysis

A balanced overall risk and return package is a necessary condition for the notional company to be able to finance its plan and attract both debt and equity capital at efficient rates and on continuous basis. Any disconnect between the likely revenue at risk and the level of allowed returns would negatively affect the sector’s access to capital.

It is critical that we have access to the capital we need to deliver our commitments to customers and to ensure financial resilience, that is, the ability to avoid, cope with and recover from disruption. As Ofwat recognised in its consultation on strengthening ring-fencing conditions, financial resilience is requisite to deliver operational performance:

“Weakened financial resilience can lead to reduced levels of operational performance and erode a company’s capacity to cope with financial pressures or shocks without compromising service to customers.”

If we are not financially resilient it will make it harder to attract and retain capital and undermine our ability to achieve a successful turnaround at the pace that we want and our customers expect. It would dramatically reduce and delay improvements for our customers and environment. Our customer research shows that customers would far rather get the right level of service than small discounts on bills. The risk mitigations we propose would allow our planned improvement in service outcomes to be delivered.

It is in the long-term interest of customers that the overall risk and return package is balanced to support financial resilience and to allow us to deliver enduring improvements in our service.

Further detail about our risk analysis is in [SRN57: Risk technical annex](#).

10.3. Uncertainty mechanisms

10.3.1. Introduction

There are a number of areas where there is material uncertainty in the parts of the business plan. Many of these uncertainties relate to legal or policy decisions that are yet to be made at the point of submission.

If we were to include costs to deliver against the more costly implications of these decisions within our plan, our plan would be significantly more costly. Also, in most cases, it is not clear whether these additional costs are required. Therefore, we have excluded these costs from our cost proposals, and set out below the uncertainty mechanisms required to provide the needed funding should these uncertainties materialise.

Some of the uncertainty areas are highly material. As such, if they were to materialise, we would require an adjustment to revenue allowances within the control period. It would not be feasible to leave any true-up to an end of period adjustment, as the business would be unable to shoulder additional costs of this scale without an associated revenue allowance. For those areas, we are seeking notified items. For other areas of uncertainty, it may be more appropriate to have an end of period true-up approach.

Therefore, we are proposing a bespoke mid-period revenue adjustment mechanism for each of the following uncertainty areas.

10.3.2. Mechanism 1: WINEP phasing

Our WINEP programmes have been phased over 8 years to balance affordability and deliverability. We are fully committed to statutory compliance and are in discussion with our regulators. The final WINEP phasing will be concluded through the regulatory process to maintain full statutory compliance. Rephasing from 8 years to 5 years would add £725 million (2022/23 prices) of further investment into the Plan and add approximately £100 to bills per household over the PR24 period. We note that the uncertainty mechanism would allow for additional funding, but does not resolve the core issues of affordability and deliverability of an unphased WINEP investment.

10.3.3. Mechanism 2: WRMP finalisation

Our WRMP has not yet received final sign-off from the Secretary of State. Until it does, it is possible that the final set of schemes may need to change (or their delivery dates). In addition, given the high-profile nature of our WRMP, it is possible that our plan will be subject to a public enquiry. If these events were to happen, there could be further changes to our plan beyond 2024.

10.3.4. Mechanism 3: Enhanced Network and Information Systems (NIS) requirements

In June 2023, an enhanced cyber assessment framework (eCAF) was published for the water industry setting out the needs to accelerate work in six areas and to achieve full compliance by 31st March 2028. This requires a significant amount of additional planning and investment options to be worked through, and given the timing of this submission on 2nd October 2023, we have concluded that we need additional time to give a duly considered view of the investment changes required. Initial estimates have placed these costs in the region of £100 million. However, further work is required before we could be comfortable to propose a figure for customers to provide funding for.

10.3.5. Mechanism 4: Bioresources farming rules for water

There is significant uncertainty surrounding the application of Rule 1 of the Farming Rules for water, including its timing and impact. Based on the national landbank modelling assessment, it is possible that two thirds of our sludge would need to find alternative routes (rather than recycling to agriculture). The short-term solution would be to send our biosolids to landfill whilst we start developing our plans for thermal destruction type of technologies (e.g. incineration) in AMP8 (design, planning), with the view to start construction in AMP9. The estimated AMP8 costs would be circa £83 million.

10.3.6. Mechanism 5: Bioresources Industrial Emissions Directive (IED)

Within our IED proposals for AMP8, there are a number of material uncertainties, including:

- If the EA does not accept our alternative impermeable surface option, we would incur circa £24 million additional costs
- If Ofwat does not approve our Kent consolidation cost adjustment claim proposals it would mean an extra circa £54 million costs for IED compliance
- Further potential cost implications from the emerging EA requirements on dewatering of the order of £169 million

In total, this could be a further £247 million of additional costs.

10.3.7. Mechanism 6: Alternative Delivery models

We have identified several projects to progress under alternative delivery routes. At present, the majority of the projects identified are at an early stage, with most pre-tender development activities yet to commence.

As projects are developed and pre-tender activities are completed, new information can give rise to increases in estimated costs which cannot be reasonably foreseen at the time of business plan submission, nor would it be appropriate to price for such risks at an early stage in the process.

10.3.8. Mechanism 7: Capital maintenance

There is a lot of work ongoing across the water sector regarding asset health, capital maintenance and renewals levels. We are aware that multiple water companies are submitting cost adjustment claims (for example Thames Water and Wessex Water). We are also doing further work to understand our asset base and this may result in changes to the current proposed capital maintenance position. We will be undertaking further work in the Autumn/Winter 2023 and will be in a position to share further details with Ofwat by early 2024.

10.3.9. Further information

We have sought to propose uncertainty mechanisms only where there are material uncertainties, for areas that either relate to meeting statutory or legal requirements, or areas of high customer priority.

It is possible that clarity on some of the above areas will be reached ahead of the final determinations (in particular, this may be the case for the WINEP, WRMP, NIS requirements, and capital maintenance). Where this is the case, we propose to provide an updated set of data tables and enhancement cases to Ofwat to reflect in the final determination, and to withdraw the request for uncertainty mechanisms in these areas.

Further details on each of the mechanisms is set out in [SRN58: Uncertainty Mechanisms technical annex](#).

10.4. Cost of capital

10.4.1. Introduction

The Final Methodology set out an expectation for companies to base their business plans on the early view of the allowed return on capital, or to propose an alternative view of the allowed return supported by compelling evidence that another rate is more appropriate. Ofwat have subsequently clarified¹ that companies which adopt the Final Methodology early view can update for more recent data – provided the update is based on the same methodology and a reasonable view of the data, and it would be unlikely to fail the minimum expectation for the allowed return set out in the quality and ambition assessment (QAA).

For our plan we have adopted the OFWAT Final Methodology early view of the allowed return updated for more recent market data. We have also considered where the updated cost of equity sits within the range provided in the Ofwat Final Methodology.

However, there are areas where we disagree with the Ofwat Final Methodology calculation of the return on capital which fails to adequately consider, or address, our assessment of the risk and funding cost faced by the notional geared company (see section 10.2 above).

[SRN57: Risk technical annex](#) and [SRN64: Cost of Capital technical annex](#) provide more details of our assessment of risk and the adjustment required to the Southern Water cost of capital to reflect the level of risk, and asymmetry of the risk, of the notional geared company. We also explain other areas of the Southern Water cost of capital where further adjustment to the approach is required.

Although our plan uses a cost of capital based on Ofwat's Final Methodology for convenience, it is essential that our representations on the calculation of the Southern Water cost of capital are accepted by Ofwat to rebalance the risk. We note further that the asymmetry premium within our calculation of the cost of equity could be reduced if Ofwat agrees to rebalancing of the risk beyond that we have proposed. (Southern Water WACC, summarised in 10.4.2 below).

In summary:

- The Ofwat Final Methodology early view of the appointee costs of capital was 3.29%
- The appointee Ofwat cost of capital used in our plan is 3.83%. We have updated the market data and considered where the cost of equity sits within the range provided in the Ofwat Final Methodology
- Our assessment of the appointee Southern Water WACC is 4.58%, this is summarised in 10.4.2. below, and explained within the Risk and Cost of Capital Annex

¹ email received on 8th September 2023

10.4.2. Ofwat cost of capital used in our plan

For our Plan we have used an appointee Ofwat cost of capital of 3.83%

We have adopted Ofwat's Final Methodology early view of the allowed return updated for more recent market data:

- We have updated the risk-free rate to 1.48% reflecting index-linked gilt yields at June 2023
- Cost of new debt, at 3.67%, reflects June 2023 iBoxx A/BBB, and an adjustment for an outperformance wedge included in the Final Methodology early view
- Cost of embedded debt, at 2.50%, is based on Ofwat balance sheet model updated to reflect June 2023 iBoxx A/BBB
- 25% new debt based on new debt issuance required under a notional structure to fund SRN's PR24 capital programme and corresponding RCV growth

We have also considered where the updated cost of equity sits within the range provided in the Ofwat Final Methodology.

We have used a Total Market Return of 6.92%, which is consistent with the Upper-bound range for the cost of equity presented in the Final Methodology. We have used the Upper-bound value, rather than the mid-point used for the early view, to reflect our assessment of the higher risk, and asymmetric risk, for the notional geared company.

We have also used the Upper-bound value for Beta, at 0.64%, rather than the mid-point used for the early view, to reflect our assessment of the higher risk, and asymmetric risk, for the notional geared company.

Table 4: Ofwat and Southern Water cost of capital calculations for use in this plan

WACC (CAPM)	Ofwat Final Methodology (Sep cut-off)	Ofwat Final Methodology (Lower - bound)	Ofwat Final Methodology (Upper - bound)	SRN Plan Ofwat WACC
Risk-free rate	0.47%	0.47%	0.47%	1.48%
Debt premium	2.81%			2.19%
Cost of embedded debt	2.34%			2.50%
% of embedded debt	83.0%			75.0%
Debt fees	0.10%			0.10%
Cost of debt	2.60%			2.89%
Equity risk premium	5.99%	5.53%	6.45%	5.44%
Beta	0.61	0.58	0.64	0.64
Cost of equity	4.14%	3.67%	4.60%	4.96%
Gearing	55.0%	55.0%	55.0%	55.0%
Allowed return	3.29%			3.83%
Retail	0.06%			0.06%
Wholesale	3.23%			3.77%
TMR	6.46%	6.00%	6.92%	6.92%

It is important to note that, while our Plan uses the Ofwat Final Methodology early view for the Ofwat cost of capital for convenience, the Southern Water Board will not be able to accept a Final Determination which does not reflect our representations on the calculation of the Southern Water cost of capital.

10.5. Financial levers and financeability

10.5.1. Setting Pay As You Go rates

Pay As You Go (PAYG) rates within our plan has been based upon the natural rates of operating costs and capital expenditure, net of associated grants and contributions, for each price control.

We consider a calculation of PAYG on natural rates to be the most appropriate approach as it ensures intertemporal fairness for our customers, the use of natural rates provides the most transparent relationship between PAYG and operating costs and is the preferred approach for credit rating agencies when assessing interest cover ratios. Our customer engagement on PR24 has been on the basis of using natural rates.

The table below illustrates the calculation of PAYG rates.

Table 5: PAYG rates

2022/23 prices	2025—26		2026—27		2027—28		2028—29		2029—30		AMP8	
	Capex £m	Opex £m	Capex £m	Opex £m	Capex £m	Opex £m	Capex £m	Opex £m	Capex £m	Opex £m	Capex £m	Opex £m
Wholesale Totex net of grants and contributions												
WR	40.386	62.528	47.002	52.692	46.902	48.356	30.425	47.594	18.717	46.378	183.432	257.548
WN	351.648	158.127	327.851	147.803	256.183	139.931	258.879	136.499	231.327	136.895	1425.888	719.255
WWN	348.228	199.582	570.447	214.024	533.021	208.423	431.048	199.015	289.326	209.949	2172.070	1030.993
BR	81.836	29.549	78.128	29.516	21.747	28.644	21.874	25.916	22.732	25.685	226.317	139.310
Wholesale net	822.098	449.786	1023.428	444.035	857.853	425.354	742.226	409.024	562.102	418.907	4007.707	2147.106
PAYG WR		60.76%		52.85%		50.76%		61.00%		71.25%		58.40%
PAYG WN		31.02%		31.07%		35.33%		34.52%		37.18%		33.53%
PAYG WWN		36.43%		27.28%		28.11%		31.59%		42.05%		32.19%
PAYG BR		26.53%		27.42%		56.84%		54.23%		53.05%		38.10%

10.5.2. Setting RCV run-off

The Ofwat Final Methodology set out an expectation that companies are not to propose RCV run-off rates that are higher than those allowed at PR19 or that are above the guidance set out in the Ofwat Final Methodology (summarised in the table below).

Table 6: Ofwat Final methodology guidance for RAC run-off rates

Ofwat Final Methodology	Water resources	Water network plus	Wastewater network plus	Bioresources
Upper Limit	4.50%	4.50%	4.50%	8.00%
SRN Appendix 10*	4.99%	4.42%	4.37%	5.77%
SRN PR19	6.75%	3.85%	5.24%	9.92%
SRN calculation	5.30%	4.36%	4.42%	6.37%
SRN Plan	4.50%	4.36%	4.42%	6.37%

*Ofwat Final Methodology, Appendix 10, Annex B "Depreciation rates derived from average asset lives"

The Ofwat Final Methodology also stated that companies should take account of intertemporal fairness, affordability, the Ofwat Final Methodology guidance on upper limits, and financeability. Companies can also propose separate RCV run-off rates for existing RCV at 31 March 2025 and new investment over 2025–2030.

Our approach has been to adopt the guidance in the Ofwat Final Methodology for the calculation of the depreciation rates and using these as the RCV run-off rates:

1. We have calculated the depreciation rates for 2022–23 in line with the Ofwat Final Methodology, Appendix 10, Annex B
2. We have compared against the PR19 depreciation rates, and the upper limit stated in the Ofwat Final Methodology
3. We have reduced the depreciation rate for Water Resources from 5.30% (calculated rate) to 4.50% (Ofwat Final Methodology Upper limit). This is a small change to the overall level of RCV depreciation for the wholesale business, reducing wholesale depreciation rate from 4.52% to 4.49%

It is worth noting that the depreciation rates calculated for Appendix 10, Annex B, of the Final Methodology omitted depreciation on intangible assets (primarily capitalised IT expenditure) and did not deduct the value of assets under construction, from the net book value, prior to calculating depreciation. Assets under construction are included in net book value but are not depreciated until commissioned.

Updating depreciation rates for these omissions would materially increase RCV run-off rates. An example is that the WWN depreciation rate would increase from 4.42% to 5.09%. The Ofwat Final Methodology Upper Limits may also be understated if they were based upon the tables in Appendix 10, Annex B.

The table below illustrates depreciation rates including intangible assets and adjusted for assets under the course of construction.

Table 7: Extension of depreciation rates to include Intangible assets and assets under construction

Water resource	Tangible				Intangible				Total				Total	Total adjusted for AUC			
	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	AUC	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %
Mar-20	134.8	4.2	31.7	3.15%	4.5	1.8	2.5	39.91%	139.3	6.0	23.1	4.34%	42.6	96.6	6.0	16.0	6.25%
Mar-21	153.4	4.6	33.5	2.98%	5.4	0.1	38.2	2.62%	158.8	4.7	33.7	2.97%	52.3	106.5	4.7	22.6	4.43%
Mar-22	179.8	9.0	20.0	4.99%	5.8	0.2	23.5	4.26%	185.6	9.2	20.1	4.97%	72.2	113.5	9.2	12.3	8.13%
Mar-23	197.3	10.5	18.9	5.30%	5.5	0.1	42.3	2.36%	202.9	10.6	19.2	5.22%	69.9	133.0	10.6	12.6	7.97%

Water Network +	Tangible				Intangible				Total				Total	Total adjusted for AUC			
	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	AUC	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %
Mar-20	1,309.6	53.7	24.4	4.10%	3.3	0.5	6.7	14.98%	1,312.9	54.2	24.2	4.13%	192.7	1,120.2	54.2	20.7	4.84%
Mar-21	1,363.7	56.9	24.0	4.17%	2.7	0.7	3.6	27.46%	1,366.4	57.6	23.7	4.22%	219.3	1,147.1	57.6	19.9	5.02%
Mar-22	1,465.6	64.8	22.6	4.42%	2.1	0.5	3.9	25.48%	1,467.7	65.4	22.5	4.45%	201.5	1,266.2	65.4	19.4	5.16%
Mar-23	1,596.9	69.7	22.9	4.36%	0.9	0.5	1.7	57.38%	1,597.7	70.2	22.8	4.39%	303.0	1,294.7	70.2	18.5	5.42%

Source: Southern Water analysis

Table 7: Extension of depreciation rates to include Intangible assets and assets under construction

Wastewater Network +	Tangible				Intangible				Total				Total	Total adjusted for AUC			
	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	AUC	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %
Mar-20	4,330.7	164.6	26.3	3.80%	22.9	9.1	2.5	39.87%	4,353.6	173.7	25.1	3.99%	600.1	3,753.5	173.7	21.6	4.63%
Mar-21	4,361.5	179.2	24.3	4.11%	33.7	10.5	3.2	31.20%	4,395.2	189.7	23.2	4.32%	435.9	3,959.3	189.7	20.9	4.79%
Mar-22	4,480.1	196.0	22.9	4.37%	64.9	17.4	3.7	26.86%	4,545.0	213.4	21.3	4.70%	371.2	4,173.8	213.4	19.6	5.11%
Mar-23	4,689.7	207.4	22.6	4.42%	78.0	16.9	4.6	21.68%	4,767.7	224.3	21.3	4.70%	362.6	4,405.1	224.3	19.6	5.09%

Bio-resources	Tangible				Intangible				Total				Total	Total adjusted for AUC			
	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %	AUC	Net Book value £m	Depreciation charge £m	Average remaining life years	Depreciation charge %
Mar-20	322.2	19.6	16.4	6.08%	0.1	0.0	10.2	9.79%	322.3	19.6	16.4	6.08%	32.9	289.4	19.6	14.8	6.78%
Mar-21	317.4	20.1	15.8	6.33%	0.2	0.0	15.3	6.56%	317.6	20.1	15.8	6.33%	28.7	288.8	20.1	14.4	6.96%
Mar-22	337.9	19.5	17.3	5.77%	0.2	0.0	202.0	0.50%	338.1	19.5	17.3	5.76%	7.8	330.3	19.5	16.9	5.90%
Mar-23	341.4	21.7	15.7	6.37%	0.0	0.0	0.0	0.00%	341.4	21.7	15.7	6.37%	13.6	327.8	21.7	15.1	6.63%

Source: Southern Water analysis

Our approach has been to follow the Ofwat Final Methodology guidance and use the depreciation rates of tangible assets only. This provides a level of RCV run-off which is sympathetic to the impact on customer bills from a higher RCV run-off rate (which would be the case by including intangible depreciation and adjusting for assets under construction) whilst also maintaining a level of RCV

run-off which covers the Plan level of capital maintenance expenditure. This approach also considers the balance of intertemporal fairness with customer affordability by ensuring customer bills in AMP8 are sufficient to cover capital maintenance required to maintain the company in a steady state, whilst not paying for the full potential depreciation charge.

Table 8: RCV depreciation vs capital maintenance

2022/23 prices	2025–26 £m	2026–27 £m	2027–28 £m	2028–29 £m	2029–30 £m	AMP8 £m
RCV run-off (Water)	85	98	109	117	124	534
RCV run-off (Wastewater)	236	251	267	277	282	1,313
Total RCV run-off	322	349	376	394	406	1,847
Botex (Water)	93	86	86	80	79	424
Botex (Wastewater)	199	201	205	177	168	949
Total capital maintenance	292	286	291	257	247	1,373

Source: Southern Water analysis



We have used the same depreciation rates for both pre-2025 expenditure and PR24 expenditure. There is not expected to be a material change to average asset lives for PR24 and we have maintained consistency with the Ofwat Final Methodology approach.

10.5.3. Reprofiting to support customer affordability

Our plan results in a step change in the average customer bill in the first year of AMP8, 2025–26. To reduce the impact on customers and taking account of feedback we have received from customers, we have reprofiled the revenues for both water and wastewater to reduce this step whilst not increasing the value of the average bill in the final year of AMP8. This reprofiling includes the revenue adjustments for PR19 reconciliations.

The feeder model used to calculate the revenue adjustments for PR19 reconciliations provides the financial model input for these values (Table RR6). The value of these reconciliations is £354.502 million, and the base assumption is that these reconciliation values are adjusted through customer bills in financial years 2025–26 and 2026–27. This is a material value to recover from customers over a two-year period, so we have spread the recovery over a five year period. The table below shows the output from the PR19 reconciliations feeder model and how we have reprofiled the values over five years period

We have applied the Plan wholesale cost of capital, of 3.77% (real), when reprofiling the Water Network and the Wastewater Network revenue reconciliation.

Table 9: Reprofile of revenue adjustments for PR19 reconciliations

2022/23 prices	2025–26 £m	2026–27 £m	2027–28 £m	2028–29 £m	2029–30 £m	AMP8 £m
Output from revenue reconciliation feeder model						
WR	-9.733	-0.477	0.000	0.000	0.000	-10.210
WN	151.400	-11.429	0.000	0.000	0.000	139.971
WWN	251.793	-18.572	0.000	0.000	0.000	233.221
BR	-0.302	-1.519	0.000	0.000	0.000	-1.821
Retail	-6.092	-0.567	0.000	0.000	0.000	-6.659
Natural profile	387.066	-32.564	0.000	0.000	0.000	354.502
Reprofiled revenue adjustments for PR19 reconciliations						
WR	-9.733	-0.477	0.000	0.000	0.000	-10.210
WN	27.994	29.480	30.145	31.281	32.461	151.361
WWN	46.644	49.103	50.227	52.121	54.087	252.182
BR	-0.302	-1.519	0.000	0.000	0.000	-1.821
Retail	-6.092	-0.567	0.000	0.000	0.000	-6.659
Reprofiled	58.511	76.020	80.372	83.402	86.548	384.853

Source: Southern Water analysis

Tables 10: Natural average household bill profile (after reprofiling of revenue adjustments for PR19)

Bills (£)	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Average Bill - Water - real	173	300	308	316	327	333	317
Average Bill - Wastewater - real	238	314	325	337	343	348	333
Average Bill - Combined - real	411	615	633	653	669	681	650

Bills (%)	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Average Bill - Water - real	-	73.8%	2.6%	2.6%	3.3%	1.8%	83%
Average Bill - Wastewater - real	-	32.3%	3.4%	3.7%	1.7%	1.7%	40%
Average Bill - Combined - real	-	49.7%	3.0%	3.1%	2.5%	1.7%	58%

Source: Southern Water analysis

There continues to be a step-up in bills from 2024–25 to 2025–26. Our customer engagement has established that customers would prefer a smoother bill profile, but not at the expense of a material increase to the natural closing bill for 2029–30.

We have therefore reprofiled Water Network and Wastewater Network revenues which results in £105 million of revenues being re-profiled from 2025–26.

We have presented an average combined bill for household water customers and household wastewater customers given the different balance between the

number of our water customers, approximately 1.1 million households, and our wastewater customers, approximately 2 million households:

- The average household water bill comprises Water Resource, Water Network Plus, and 36% of Retail
- The average household wastewater bill comprises Wastewater Network Plus, Bioresources, and 64% of Retail.

Tables 11: Average household customer bills after reprofiling

Bills (£)	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Average Bill - Water - real	173	264	328	330	331	333	317
Average Bill - Wastewater - real	238	291	337	344	348	348	333
Average Bill - Combined - real	411	555	665	674	679	681	650

Bills (%)	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Average Bill - Water - real	-	52.6%	24.4%	0.7%	0.2%	0.5%	83%
Average Bill - Wastewater - real	-	22.6%	15.6%	2.0%	1.2%	0.2%	40.4%
Average Bill - Combined - real	-	35.2%	19.8%	1.4%	0.7%	0.4%	58.5%

Source: Southern Water analysis

10.5.4. Dividend

A real dividend yield of 2% has been assumed for the notional geared company. This is consistent with guidance in the Ofwat Final Methodology for a company with a significant growth in the Plan from PR19 to PR24. This means equity returns in excess of £400m will be retained in the company to support the planned investments.

10.5.5. Notional financeability – approach and outputs

The Ofwat Final Methodology requires us to assess whether an efficient company with the notional capital structure will be able to generate cashflows sufficient to meet its financing needs, with reference to key financial ratios.

Table 12: Key financial ratios: reprofiled revenues

Key financial ratios	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Adjusted cash interest cover ratio (Ofwat)	1.050	1.926	1.761	1.637	1.542	1.602
Adjusted cash interest cover ratio - (Alternative)	1.050	1.926	1.761	1.637	1.542	1.602
Funds from operations / net debt (Ofwat)	7.78%	10.95%	10.30%	9.83%	9.58%	9.75%
Funds from operations / net debt - (Alternative)	6.96%	10.18%	9.53%	9.04%	8.85%	8.97%
Gearing - Appointee	58.30%	59.61%	61.02%	61.70%	61.61%	60.58%

Source: Southern Water analysis

The Plan is financeable and meets the ratios commensurate with a Baa1/BBB+ credit rating:

- The adjusted interest cover ratio meets the minimum 1.5x required to maintain a Baa1/BBB+ credit rating
- FFO/net debt meets the 9% minimum level for the ratio but is a little weak, especially the 'Alternative' calculation which is a closer match to the key Standard and Poor's financial ratio
- It is worth noting that the key financial ratios exclude the financial impact of the revenue adjustments for PR19. For SRN these amount to a real increase in revenues of £389 million over the period, which would provide support to these ratios
- Appointee gearing increases by 6.6% over the PR24 period, primarily the result of significant capital investment in PR24
- A lower, 2% real dividend yield, has been included in the Plan. This ensures equity, in excess of £400 million, is retained to help mitigate the effect of a significant capital investment programme on the key financial ratios

The closing gearing ratio, of 61.6%, also excludes the additional revenues from the PR19 reconciliations. Gearing reduces to 57.5% when we include this additional revenue.

The ratio for 2025–26 is weaker as a result of reprofiling of revenues to support customer affordability. We have reprofiled the net increase in revenues in 2025–26 for the Water Network and the Wastewater Network, of £403 million, equally over the PR24 period relieving pressure on the natural step-up in customer bills from 2024–25 to 2025–26.

The table below sets out the key financial ratios prior to the re-profiling. The first year of PR24 is significantly stronger, but the impact on the other years is not material.

We would expect credit rating agencies, and other financial stakeholders, to look through the effect of reprofiling on the first-year ratios, and we do not see this as detrimental to maintaining a Baa1/BBB+ credit rating.

Table 13: Key financial ratios: reprofiled revenues

Key financial ratios	2025–26	2026–27	2027–28	2028–29	2029–30	5yr avg.
Adjusted cash interest cover ratio (Ofwat)	1.742	1.643	1.590	1.552	1.542	1.603
Adjusted cash interest cover ratio - (Alternative)	1.742	1.643	1.590	1.552	1.542	1.603
Funds from operations / net debt (Ofwat)	10.56%	9.95%	9.65%	9.49%	9.58%	9.80%
Funds from operations / net debt - (Alternative)	9.72%	9.19%	8.88%	8.70%	8.84%	9.02%
Gearing - Appointee	57.04%	58.83%	60.74%	61.69%	61.63%	60.16%

Source: Southern Water analysis

The Plan does not require nor assume we need new equity in order to meet the calculated key financial ratio targets, The Plan does not, however, include risk. Our review of risk is covered separately within our Risk Annex, and summarised in Section 10.2 above,

Our plan adopts the Ofwat Final Methodology early view for the Ofwat cost of capital and we have calculated this to be 3.83% This Ofwat cost of capital is sufficient to meet the calculated key financial ratios but does not adequately consider the level of risk in the Plan and neither is it at a level deemed sufficient to attract the new equity required to support the business in appropriately dealing with risk scenarios.

We have therefore recommended our own view of what the cost of capital needs to be within [SRN64: Cost of capital technical annex](#), which also reflects our view the level of risk within the plan.

There is no requirement to stress test the notional geared company, and nor is there the facility to run stress tests in the provided financial model. For completeness however, we have applied stress tests to the notional capital structure and this is set out in the [SRN60: Financeability technical annex](#). This allows us to assess the correlation between the notional and actual capital structure.

10.5.6. Actual financeability – approach and outputs

We have tested actual geared financeability by taking the PR24 regulatory outputs from the notional geared model and testing against the actual capital structure. The table below sets out the results of key financial ratios for the actual geared company.

It is important to note that financial ratios only contribute 35% to 40% of the credit rating assessment. The remainder of the assessment comprises the regulatory framework and operational risk.

For the actual geared financeability assessment:

- The regulatory framework is assumed to continue to be stable and supportive of water sector ratings
- Our Turnaround Plan, supported by £905 million of new equity received during the PR19 period, is expected to reduce operational risk and strengthen the credit ratings of Southern Water for the start of the PR24 period.

Table 14: Key financial ratios: of the actual geared company (3.77% Wholesale Ofwat WACC)

YE 31 March, £m	Covenant level				2025	AMP8				
	PFI	Trigger	Default	Guidance		2026	2027	2028	2029	2030
RCV					6,992	7,990	8,923	9,669	10,282	10,688
SWS metrics										
Class A Debt / RCV	75.0%	75.0%	95.0%		74.4%	72.1%	71.8%	71.0%	69.8%	67.9%
Cash Headroom to PFI (£m)					42	233	285	382	540	761
Cash Headroom to Default (£m)					1,441	1,831	2,070	2,316	2,596	2,898
Class A Adjusted ICR (x)		1.30x			0.82x	2.30x	2.50x	2.59x	2.50x	2.21x
Cash Headroom (£m)					(56)	151	233	302	302	258
Class A ICR (x)			1.60x		3.91x	4.65x	4.53x	4.44x	4.34x	3.92x
Cash Headroom (£m)					273	461	569	664	690	661
Class A PMICR (x)			1.00x		2.16x	2.53x	2.87x	3.02x	3.15x	2.89x
Cash Headroom (£m)					137	230	364	471	541	536
Class A average adjusted ICR (x)		1.40x			0.82x	2.42x	2.45x	2.43x	2.35x	2.21x
Moody's - Adjusted gearing				75.0%	75.3%	72.7%	72.2%	71.2%	69.7%	67.8%
S&P - OpCo FFO / Debt				8.0%	4.1%	6.7%	8.8%	9.5%	9.6%	9.6%
Fitch - Adjusted Gearing				77.0%	76.8%	76.5%	75.6%	74.4%	72.8%	70.8%
Fitch adj. cash AICR				1.40x	0.83x	1.48x	2.03x	2.09x	2.03x	1.97x
Distribution					-	(43)	(49)	(54)	(59)	(64)
New equity					-	-	-	-	-	-

Source: Southern Water analysis



The plan is financeable and key financial ratios are considerably stronger than they have been for the PR19 period. Current credit ratings are Baa3/BBB+/BBB. Forecast financial ratios for the PR24 period are supportive of a recovery in the credit rating to our target level. We recognise that any recovery in the rating will also need to be supported by an overall risk that is of an acceptable level, along with improvements in our operational performance:

- All debt covenant ratios have positive financial headroom to Trigger and Default ratios
- Financial ratios commensurate with an investment grade credit rating sufficient to maintain access to the capital markets in order to efficiently finance the business
- Key credit rating ratios meet targets commensurate with Baa1/BBB+ but, similar to output from the notional geared company, financial headroom is limited and therefore support the need for the mitigation as outlined earlier in this chapter.

The company is financially resilient with appropriate headroom against its covenants and the financial metrics that support the targeted credit rating. It also has in place – and expects to fully maintain – the credit facilities and liquidity protections, along with the appropriate levels of insurance to support this resilience. However, when Ofwat’s PR24 methodology for penalties and downside adjustments is applied to the notional company, the risks to Plan are outside of the level of this resilience.

This is in part driven by a significant increase in the size of our Plan from previous AMPs, and the size of the plan relative to the size of the business. We have suggested options for Ofwat to mitigate the risk. Our final assessment on the financial resilience of the company has been made on the assumption of these mitigations.

The Ofwat Final Methodology has set out the following stress tests and the second table below summarises the results of the stress tests against the Actual geared company.

Table 15: Scenarios for stress testing

Scenario	No.
10% Totex overspend	1
ODI Penalty in Yr2 (3% RORE)	2
2% reduction to forecast inflation	3
Deflation of -1% CPIH in Yr1 and Yr2	4
High Inflation of 10% CPIH Yr1 and 5% Yr2 and Yr3, plus increased RPI/CPIH wedge	5
Bad debt increase of 20% in Yr2 and Yr3	6
Increase interest cost of 2% on new finance	7
Penalty in Yr2 of 6% of revenue	8

Table 16: Summary output of stress tests (3.77% Wholesale Ofwat WACC)

	Closing gearing, average ICR Amp 8 Metrics - 3.83% WACC										
	Threshold	AMP7	Base Case	Sc. 1	Sc. 2	Sc. 3	Sc. 4	Sc. 5	Sc. 6	Sc. 7	Sc. 8
Class A Debt/RCV %	75.0	74.4	70.8	74.9	72.2	73.2	71.9	69.3	70.9	72.9	71.6
Class A Adjusted ICR (x)	1.3	0.8	2.1	1.9	2.0	2.1	2.1	2.2	2.1	1.8	2.1
Class A ICR (x)	1.6	3.9	4.1	3.8	3.9	4.0	4.0	4.1	4.0	3.5	4.0
Class A PIMCR (x)	1.0	2.2	2.6	2.2	2.5	2.5	2.6	2.6	2.6	2.2	2.6
Class A average adjusted ICR (x)	1.4	0.8	2.1	1.8	1.9	2.0	2.0	2.1	2.1	1.7	2.1
Moody's - Adjusted Gearing %	75.0	75.3	70.7	74.8	72.1	73.2	71.8	69.2	70.8	72.9	71.6
S&P - FFO/Debt %	>[6/]8	4.1	7.7	6.6	7.3	8.7	8.3	6.2	7.7	7.0	7.6
Fitch - Adjusted Gearing %	77	76.8	73.7	76.4	75.1	76.1	75.0	72.0	73.8	75.9	74.6
Fitch - Adjusted ICR (x)	1.4	0.8	1.7	1.6	1.6	1.8	1.8	1.5	1.6	1.4	1.6
Dividend		0	269	0	269	269	269	269	269	269	269
New equity for 72% Debt/RCV (£m)		905	0	309	16	121	0	0	0	101	0

Source: Southern Water analysis

Our conclusions:

- Scenario 1, totex overspend of 10%, is the most severe scenario. A 10% overspend has a disproportionate effect on the company due the significant increase in the size of the totex in the plan. Allowed return levels generated from the existing RCV are not sufficient to cover an overspend of this size. This would require further action beyond any restriction of dividends, highlighting the need for the risk of the national company to be mitigated to align it with the risk levels set in the Ofwat methodology.
- Restricting dividend within the Plan, of £264 million, is sufficient to mitigate risk in scenarios 2, 3, and 7
- Scenario 5, high inflation, is positive for gearing but places pressure on ratios which include an adjustment for inflation accretion of financial instruments. This should not put pressure on credit ratings given the forecast recovery in inflation, and ratios, by 2030

- Scenarios 4, 5, 6, and 8, can be accommodated within a stress test gearing target of 72%

The Ofwat cost of capital in the Plan (3.83% real Wholesale Ofwat cost of capital) is at an insufficient level to attract the new equity required to support the business in appropriately dealing with risk.

The [SRN60: Financeability technical annex](#) provides further details of the stress tests, as well as results of combined scenarios

We have also tested actual financeability by updating the cost of capital to the level we believe it should be set to reflect the level of risk faced by the notional geared company and to also reflect the funding cost faced by the notional geared company.

Table 17: Key financial ratios: of the actual geared company (4.58% Wholesale Southern Water WACC)

YE 31 March, £m	Covenant level				2025	AMP8				
	PFI	Trigger	Default	Guidance		2026	2027	2028	2029	2030
RCV					6,992	7,990	8,923	9,669	10,282	10,688
SWS metrics										
Class A Debt / RCV	75.0%	75.0%	95.0%		74.4%	72.1%	71.8%	71.0%	69.8%	67.9%
Cash Headroom to PFI (£m)					42	233	285	382	540	761
Cash Headroom to Default (£m)					1,441	1,831	2,070	2,316	2,596	2,898
Class A Adjusted ICR (x)		1.30x			0.82x	2.30x	2.50x	2.59x	2.50x	2.21x
Cash Headroom (£m)					(56)	151	233	302	302	258
Class A ICR (x)			1.60x		3.91x	4.65x	4.53x	4.44x	4.34x	3.92x
Cash Headroom (£m)					273	461	569	664	690	661
Class A PMICR (x)			1.00x		2.16x	2.53x	2.87x	3.02x	3.15x	2.89x
Cash Headroom (£m)					137	230	364	471	541	536
Class A average adjusted ICR (x)		1.40x			0.82x	2.42x	2.45x	2.43x	2.35x	2.21x
Moody's - Adjusted gearing				75.0%	75.3%	72.7%	72.2%	71.2%	69.7%	67.8%
S&P - OpCo FFO / Debt				8.0%	4.1%	6.7%	8.8%	9.5%	9.6%	9.6%
Fitch - Adjusted Gearing				77.0%	76.8%	76.5%	75.6%	74.4%	72.8%	70.8%
Fitch adj. cash AICR				1.40x	0.83x	1.48x	2.03x	2.09x	2.03x	1.97x
Distribution					-	(43)	(49)	(54)	(59)	(64)
New equity					-	-	-	-	-	-

Source: Southern Water analysis

Improved forecast financial ratios with our proposed wholesale Southern Water cost of capital of 4.58%.

This plan is financeable and key financial ratios are considerably stronger than the PR19 period. Current credit ratings are Baa3/BBB+/BBB. Forecast financial ratios for the PR24 period are supportive of a recovery in the credit rating. It is, however, difficult to predict the pace of recovery in the credit ratings given the need to also demonstrate an improvement in operational performance (from the turnaround plan):

- All debt covenant ratios have positive financial headroom to Trigger and Default ratios, and closing debt/RCV at March 2030 is comfortable at c. 68%
- Financial ratios commensurate with an investment grade credit rating sufficient to maintain access to the capital markets in order to efficiently finance the business
- Key credit rating ratios meet targets commensurate with Baa1/BBB+

We have also carried out the stress tests, set out in the Ofwat Final Methodology, against the plan with our proposed Wholesale Southern Water cost of capital of 4.58%.

The table below summarises the results of the stress tests:

Table 18: Summary output of stress tests (3.77% Wholesale Southern Water WACC)

	Closing gearing, average ICR Amp 8 Metrics - 3.83% WACC										
	Threshold	AMP7	Base Case	Sc. 1	Sc. 2	Sc. 3	Sc. 4	Sc. 5	Sc. 6	Sc. 7	Sc. 8
Class A Debt/RCV %	75.0	74.4	67.9	74.7	69.1	70.2	69.0	66.4	68.0	70.0	68.8
Class A Adjusted ICR (x)	1.3	0.8	2.4	2.1	2.3	2.4	2.4	2.5	2.4	2.1	2.4
Class A ICR (x)	1.6	3.9	4.4	4.0	4.3	4.3	4.3	4.4	4.4	3.7	4.3
Class A PIMCR (x)	1.0	2.2	2.9	2.4	2.8	2.8	2.9	2.9	2.9	2.4	2.9
Class A average adjusted ICR (x)	1.4	0.8	2.4	2.1	2.2	2.3	2.3	2.4	2.4	1.9	2.3
Moody's - Adjusted Gearing %	75.0	75.3	67.8	74.7	69.1	70.2	68.9	66.4	68.0	70.0	68.7
S&P - FFO/Debt %	>[6]/8	4.1	8.9	7.5	8.4	9.9	9.4	7.3	8.8	8.1	8.7
Fitch - Adjusted Gearing %	77	76.8	70.8	76.2	72.1	73.1	72.1	69.1	70.9	73.0	71.7
Fitch - Adjusted ICR (x)	1.4	0.8	1.9	1.8	1.8	2.1	2.0	1.7	1.9	1.6	1.9
Dividend		0	269	269	269	269	269	269	269	269	269
New equity for 72% Debt/RCV (£m)		905	0	289	0	0	0	0	0	0	0

Source: Southern Water analysis

Our conclusions:

- Scenario 1, Totex overspend of 10%, is the most severe scenario, especially given the size of the PR24 plan as explained above. Further action, beyond withholding dividends, would be required to maintain credit ratings with this level of overspend. The impact of this scenario is reduced with the higher WACC. Mitigation of risk for the notional company is still required.
- Financial headroom within the Plan is sufficient to accommodate the other ratios
- The Financeability Annex provides further details of the stress tests, as well as the results of the combined scenarios

10.5.7. Board assurance of financeability

There are a number of areas where there is material uncertainty in the parts of the business plan. Many of these uncertainties relate to legal or policy decisions that are yet to be made at the point of business plan submission. Detail on these uncertainties identified by our plan is provided in chapter [SRN11: Data and Assurance](#), including those, noted below, pertinent to our Risk and Return. These have overlap with the uncertainty mechanisms mentioned earlier in this chapter.

Regulator agreement EA – WRMP: Our plan is based on our dWRMP24 which has not been signed off by the Secretary of State and hence is subject to change.

Our proposed environment programme and Water Resources Management Plan require a step change in investment to an unprecedented level, and this plan is four times larger than our equivalent plans in AMP7. This submission and linked WRMP submissions in August and September 2023 do not yet close all the deficits. We will work with regulators to develop and agree potential mitigations over the medium term to provide drought contingency as the solutions are built.

Regulator agreement EA – WINEP phasing: To address affordability and deliverability concerns our plan is based on a proposed reprofiling of WINEP, which is being considered by our regulators.

Our proposed WINEP investment is close to requiring the total five-year AMP7 level of investment every year of the AMP8 period. We continue to work with the EA, alongside DEFRA and Ofwat, to find sustainable ways to deliver these programmes in a timeframe that is deliverable, having regard to the existing supply chain constraints and can be afforded by our customers. Without the proposed re-phasing the plan is neither affordable nor deliverable.

Regulator agreement Ofwat – alternative delivery: significant use of alternative delivery mechanisms.

Prior to submission Ofwat has yet to agree to c. £1.3 billion of Alternative Delivery projects and these remain subject to agreement at business plan submission. We support this Alternative Delivery and its benefit of freeing up internal resource on the delivery of other plan elements.

Scale and challenges of Deliverability – deliverability of a plan that is nearly twice the size of AMP7 and supply chain challenge.

Our plan will see a doubling of our current investment programme. Delivering investment at this scale and pace will be a challenge – particularly given our performance and delivery has not been where it needed to be. We have identified new strategies to mitigate this challenge, including an updated supply chain strategy, new approach to portfolio planning delivery and performance, and a strategic workforce review. Increased investment programmes across the entire UK water sector will heighten demand on, and scarcity in the supply chain.

For more detail of our Board Assurance in this area please refer to the Financeability and Financial Resilience elements of our supporting material in chapter [SRN11: Data and Assurance](#).

As a Board we have had to debate and make difficult trade-offs. Not everything we would like to do can be financed or delivered in the timescale we would ideally like to see. Elements of our investment programme are subject to uncertainty mechanisms because there is continuing regulatory engagement on the form and timing of delivery, and we propose innovative alternative investment structures to secure our desired full programme.

Given the challenges the water sector as a whole face and the scale of investment required, and against a background of volatility in interest rates, we believe there is a growing need for the sector to attract new equity capital, based on reasonable risk and reasonable returns. Our plan assumes risk mitigation that allow an appropriate risk and return that was not possible on the basis of notional company risk modelling.

For more detail please see chapter [SRN11: Data and Assurance](#).

10.6. Dividend policy

10.6.1. Introduction

Our dividend policy for the 2025-2030 period will ensure a fair and balanced reward between customers, stakeholders and investors. When we are successful in the delivery of our business plans, all stakeholders share in our success: customers benefit through environmental and water resilience improvements, better services and lower bills, and shareholders earn a fair return on the money they have invested.

Our dividend policy is reviewed annually by the Board and published in our Annual Report each July. No material changes are currently planned to be made to the existing policy ahead of the next investment period (2025–30) but the Board will keep this under review. Therefore, the dividend policy for the 2025–30 period will follow the principles below. [See SRN63: Executive Pay and Dividend technical annex](#) for further detail.

10.6.2. Dividend policy

When proposing payment of a dividend, the directors of Southern Water Services Limited, acting independently in accordance with their directors' duties and in accordance with the company's licence, will apply the following principles:

1. Determination of a base level of dividend, based on an equity return consistent with our most recent Final Determination and our actual level of gearing. This recognises our management of economic risks and capital employed

2. In assessing any adjustment to the base level of dividend, we will take into account all aspects of our performance and consider this in the round. This would reflect our overall financial performance as compared to the final business plan as agreed by Ofwat and would explicitly consider a qualitative assessment of customer service levels, performance against planned customer and environmental outcomes and how customers share in our successes
3. We will consider our financial resilience ahead of any dividend decision and whether any financial out-performance should be reinvested to benefit customers. This consideration will include taking into account the interests of our employees, other stakeholders, and our pension schemes. Our dividend policy is intended to support the financial resilience and investment grade credit ratings of the business and ensure continued access to diversified sources of finance. As part of step three, we carry out an assessment of:
 - Headroom under debt covenants
 - The impact on the company's credit rating
 - The liquidity position and ability to fulfil licence conditions
 - Key areas of business risk
4. We will be transparent in the payment of dividends and will clearly justify the payment in relation to the factors outlined above
5. We will publish our dividend policy annually (in the Annual Report) and highlight any changes

10.7. Executive pay policy

10.7.1. Introduction

Our remuneration policy sets out how we set seek to attract, recruit and retain the talented individuals required to deliver the requirements of our business plan and we will extend that policy for the 2025–30 period to continue to ensure alignment with delivery for:

- Customers;
- The environment; and
- Shareholders and other stakeholders

This is consistent with Ofwat's expectations in its final methodology and other guidance. This section sets out the core tenets of our policy. See [SRN63 Executive Pay and Dividend technical annex](#) for further detail.

10.7.2. Factors that have determined our policy

It is our policy to:

1. Ensure that performance related executive pay has a clear alignment to delivering stretching performance improvement, which is in the interests of customers as well as providing sustained and long-term value creation for shareholders and other stakeholders, and protecting the environment. An additional incentive linked to longer term targets has been implemented with effect from 1 April 2023
2. Provide transparent alignment between performance-related pay and stretching outcomes for all our stakeholders and specifically including our customers
3. Apply stretching targets linked to customer and environmental outcomes. 50% of bonus targets relate to outcomes for customers that require stretching performance. These do and will include customer outcomes such as ODIs, C-Mex, efficiency of service delivery, as well as acknowledging the importance of the environment to our customers
4. Apply rigorous application of scheme rules and to provide independent governance of remuneration decisions through the Board Remuneration Committee, whilst taking into consideration risk management principles
5. Apply good corporate governance by taking into account regulatory requirements and, among others, the UK Corporate Governance Code, any corporate governance principles or guidance issued by Ofwat
6. Take into account the remuneration practices found in other UK companies of a similar size or operating in the same sector