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1. Executive summary

In accordance with the timetable specified by Ofwat, the Company is submitting representations on the Draft Determination issued on 29 August 2014. These representations have been informed by expert technical advice, subjected to independent assurance and approved by the whole Board, who have approved the assurance statement included at Appendix 1.

In considering how to approach these representations, the Board has used as its touchstone the very clear messages on customer priorities and perspectives obtained from the extensive engagement programme undertaken throughout the duration of the PR14 price review process. This continues the Board’s absolute commitment to ensuring that customers are at the heart of the process, and that the Company’s Plan – and an acceptable Final Determination – accords the highest priority to reflecting customers stated preferences.

Before approving these representations, the Board reviewed the whole suite of customer research undertaken over the last two years to ensure that the research findings were at the forefront of its mind when considering the overall tenor of this submission. The presentation of this research overview to the Board by Accent noted “The extent of the PR14 customer engagement programme represents a significant shift in the role that customers have played as part of SESW’s Business Plan”.

The Company has focused its representations on a limited number of key areas where there are material differences between the Company’s Plan and the Draft Determination. The representations therefore provide a genuine attempt to reach a compromise which delivers what customers have told the Company they expect within a sustainable framework acceptable to all stakeholders. Issues not raised in these representations may be revisited in the event that such a compromise cannot be achieved.

The key areas addressed by these representations are:

- Modifications to the target performance commitments for interruptions to supply, drinking water quality and per capita consumption
- Additional totex for Wholesale activities to cover above average pumping head (£3.3m) and the new costs for street works permits (£2.1m)
- An increase in Household Retail costs of £7.0m, comprising £2.8m for input price pressures and £4.2m for cost to serve allowances
- £1.7m for a 15 basis points (bps) uplift to the allowed cost of capital
- An adjustment to annual PAYG ratios to achieve a flat bill profile throughout AMP6
- A shorter initial control period for non-household default tariffs

These key areas of focus for representations implicitly exclude other areas where the Company considers the Draft Determination is in some respect flawed, but are not being challenged as part of these representations. These include:

- Modifications to target performance commitments that do not reflect the priorities of the Company’s customers
- Totex benchmarking that generates historic efficiency assessments contrary to all previous benchmarking and inconsistent with assessments of forecasts of future expenditure
- Funding of pension deficit costs based on out of date and skewed data
Sutton and East Surrey Water  
**Representation to Draft Determination**

- An assessment of the company-specific adjustment to the allowed cost of capital that is understated and ignores important evidence
- Failure to allow a mechanism for taking into account material uncertain items outside management control that are not funded in Determinations

The net impact over AMP6 of the Company’s representations is to reduce average household bills by £2 pa relative to the Company’s Business Plan and increase them by £6 relative to the Draft Determination. More significantly, the adjustment to annual PAYG ratios avoids the initial increase in 2015/16 and subsequent real reductions, providing greater stability in bills customers will face for the next five years. The profile of average household bills is shown in Table 1 and illustrated in Figure 1 below.

**Table 1: Average bill**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Plan</td>
<td>179</td>
<td>187</td>
<td>181</td>
<td>179</td>
<td>176</td>
<td>171</td>
</tr>
<tr>
<td>Ofwat DD</td>
<td>176</td>
<td>180</td>
<td>173</td>
<td>169</td>
<td>165</td>
<td>160</td>
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<tr>
<td>Company Representation</td>
<td>178&lt;sup&gt;1&lt;/sup&gt;</td>
<td>176</td>
<td>176</td>
<td>176</td>
<td>176</td>
<td>176</td>
</tr>
</tbody>
</table>

<sup>1</sup> Differs from Company Plan due to minor rounding differences

![Figure 1](image-url)

The revised bill profile also helps address financeability issues in later years by maintaining bills (and revenues) at a stable level.

The rest of these representations follow the order of the Draft Determination, dealing with Wholesale, Retail Household and Retail Non Household matters before addressing issues at the overall Appointed Business level. Key issues are addressed first in each section, with
subsequent reference to other, less material matters that could relatively easily be addressed as part of Final Determinations.
2. Wholesale water

2.1. Company outcomes, performance commitments and delivery incentive

2.1.1. Summary

In its Draft Determination Ofwat has amended seven of our proposed Performance Commitments PCs and/or Outcome Delivery Incentives.

The following table summarises our position on each of those amended PCs:

<table>
<thead>
<tr>
<th>Ref</th>
<th>Performance commitment</th>
<th>Ofwat draft determination</th>
<th>Our position</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>Dry year SoSI Addition of a penalty</td>
<td>Accept, but add a caveat regarding sustainability reductions</td>
<td></td>
</tr>
<tr>
<td>A3</td>
<td>Supply interruptions Changes to the PC, the deadband, penalty collar and reward cap</td>
<td>We have proposed alternatives</td>
<td></td>
</tr>
<tr>
<td>A4</td>
<td>Condition of the mains network – bursts Tightened the deadband</td>
<td>We consider the original deadband was appropriate, but are prepared to accept change</td>
<td></td>
</tr>
<tr>
<td>A5</td>
<td>DWI water quality index Tightened the deadband and added a collar</td>
<td>Accept the introduction of a collar, but we have proposed an alternative deadband</td>
<td></td>
</tr>
<tr>
<td>A6</td>
<td>Water quality – taste, odour and discoloration Altered the penalty collar and reward cap</td>
<td>We consider the original collar and cap were appropriate, but are prepared to accept change</td>
<td></td>
</tr>
<tr>
<td>C2</td>
<td>Resilience – percentage of properties connected to more than one treatment works Altered the penalty collar and reward cap</td>
<td>We consider this provides no incentive to try and bring forward the programme if possible, but are prepared to accept</td>
<td></td>
</tr>
<tr>
<td>E2</td>
<td>Per capita consumption and metering Reward and link to metering removed</td>
<td>Link to metering must be reinstated and would appreciate the option of a reward if we are able to bring metering programme forward</td>
<td></td>
</tr>
</tbody>
</table>

2.1.2. Introduction

We submitted a revised set of ODIs in our Business Plan Resubmission (dated 27 June 2014), amended slightly by the ODI template submitted by email on 18 August 2014. Ofwat’s new approach to assess Outcome Delivery Incentives (ODIs) by comparing performance levels across companies has led to Ofwat proposing changes to our ODIs in seven instances. This note provides our view on these adjustments and outlines why, in some cases, the adjustments should be viewed as long-term rather than short-term goals.
We first comment on the general issues with the horizontal crosscheck and then provide detailed discussion for each intervention.

Overall, our approach to ODIs and associated targets is that they should be designed to meet the following overall principles:

- encourage improved performance;
- penalise poor performance; and
- reward good performance.

**Ensuring that customer preferences and valuations are reflected**

Based on the overall principles, we would expect that in general:

- rewards and penalties should strike an appropriate balance over the AMP;
- the Company should not be rewarded for improved performance unless customers have indicated that they are willing to pay for improved performance; and
- the Company should not be penalised for failing to improve performance unless the customers have indicated that they are willing to pay for improved performance.

The key issue with horizontal assessment and subsequent intervention is that it leads to adjustments that do not reflect our customers’ preferences or valuations. Throughout the PR2014 price control process, Ofwat has emphasised that companies should focus on delivering what customers want. For example, one of Ofwat’s criteria for assessing business plans was: “How well has the company demonstrated that its proposed outcome commitments are consistent with the interests of consumers in the longer-term (in particular that its activities and outcomes will be economic and efficient in the longer term)?” (Ofwat, 2013, Final methodology, page 77). Similarly, Ofwat stated that: “This means that Boards of companies should focus on what their customers want rather than what the regulator wants.” (Ofwat, 2013, Final methodology, page 5). We agree with this principle and have carried out extensive customer engagement.

Ofwat’s interventions that are based on the new horizontal assessment of ODIs do not reflect the findings from our customer engagement process such as willingness-to-pay (WTP) research or engagement with the Customer Challenge Group (CCG) on appropriate measures. Research on customer acceptability of the Plan is also not reflected. This runs the risk of undermining the legitimacy of the customer engagement and could create serious issues around the credibility of the engagement for future price controls.

We therefore conclude that the interventions based on horizontal assessment should be adjusted to reflect better our customers’ views. At least in the short-term, customers’ valuations of improvements should inform the timing of upper quartile adjustments. For example, it would be in the interests of customers to subject the interventions on Performance Commitments (PCs) to the usual approach to cost-benefit analysis to ensure that customers do not pay more for an improvement than the value they indicated during the customer research.

**Relationship between costs and performance**

Ofwat states that: “Customers have paid for upper quartile performance and should receive it as soon as is possible. Our totex calculations have been based on funding companies to
deliver upper quartile efficiency” (Setting Price Controls for 2015-20: Page 19 of Appendix A2). For Ofwat’s statement to be true, the companies with the lowest costs would have to be the ones with upper quartile performance. However, this is not necessarily the case as upper quartile efficiency is not always achieved by those companies that operate at upper quartile Performance Commitments. Ofwat’s approach is only valid if the upper quartile companies for cost efficiency and ODI Performance Commitments are identical.

In practice, it is difficult to discern a distinct pattern between cost efficiency and performance. Figure 1 shows performance on supply interruptions versus the cost efficiency score. It shows that the average of the performance of the three most efficient companies is above the 10 minute performance commitment that Ofwat has set. While this is only one dimension of performance, it illustrates that the most efficient companies are not always performing within the upper quartile.

Figure 1. Supply interruptions performance commitment vs efficiency score

The figure above does not include the enhanced companies or those with early determinations. For example, South West Water had a high cost efficiency score but its performance on the interruptions measure is at 16.2 min and its performance commitment is 12 min.

While we do not disagree with the general principle of comparing industry performance, it is important for Ofwat to keep in mind that different performance levels are often associated
with different costs and not all companies can achieve the same performance level with the
same costs. We suggest therefore, that as ODIs and PCs are taken forward into future
reviews, a better way to identify a common performance level would be to reflect different
companies’ circumstances in the PC. For example, exogenous factors such as geology or
factors that would take a long time to influence such as network configuration should be
reflected in the interventions.

Minimise risk of unintended consequence and ineffective incentives
While we agree that it is a good thing in general to be encouraging companies to strive to
achieve a common standard of performance, we believe the timescale for achieving that
common standard should be realistic and achievable. Any improvement required over a
regulatory period (or longer time frame) needs to take into account:
• starting point (where a company is compared to other companies);
• the specific circumstances of the company (e.g. geology, age of the mains network,
average pumping head, extent and size of district meter areas, meter penetration);
• improvement is not necessarily linear compared to the spend required.

Ofwat’s interventions run the risk of creating unintended consequences and ineffective
incentives. This could arise, for example, if a company could not achieve the PC without
increasing its costs beyond the penalty levels. We want to ensure that the risk of unintended
consequences is minimised. It follows that interventions to performance commitments
should be achievable and realistic. These principles have generally been applied to
regulatory determinations in the past. For example, in previous water sector price controls
the cost efficiency improvements reflected those principles. We have therefore considered
each of the interventions against these criteria.

2.1.3. Performance commitment A1: Security of supply index (SOSI) dry year average
Ofwat’s position
Ofwat has added a penalty of £0.2m per SoSI number below 98.

Our position
We are prepared to accept the addition of Ofwat’s proposed penalty on this performance
commitment. However, we think it is appropriate that a caveat is added that a penalty will
not be applied should the Company’s deployable output be reduced as result of sustainability
reductions applied by the Environment Agency (assuming any such sustainability effectively
reduce the SOSI below 100).

2.1.4. Performance commitment A3: Supply interruptions
Ofwat’s position
Ofwat has set a much higher performance commitment, has amended the penalty collar and
reward cap, and altered the deadband.

Our position
The revised targets, limits and deadband make this a very onerous PC. Had these figures
applied to our performance over the last five years, we would have paid penalties of £612k
and gained rewards of £16k, giving a net loss of £596k.
It will be very difficult, and expensive for us to achieve the higher PC because of legacy
issues with the network including:
• chalk and iron deposits within the network; and
• a lack of interconnectivity within the network.

Ofwat’s proposed PC fails to acknowledge these points which are discussed in more detail below.

We believe that the ODI included in our revised Business Plan submission presented a challenging enough target, however, understanding the desire to show continuous improvement, we propose a revised ODI that includes a steadily improving level of performance. See our proposal below.

**General**

Ofwat’s interventions imply that we have to improve performance against our original PC of 0.30 hours by 43% to 0.17 hours.

It is useful to consider how much our customers value an improvement in this measure. Our WTP research suggests that customers value interruptions at £94 per property affected by an incident of over three hours. This figure represents an average between planned and unplanned interruptions. To derive the total WTP to avoid all interruptions over three hours, this value is multiplied by the number of interruptions over three hours, averaged over the years from 2010/11 to 2012/13. This gives a WTP to avoid all interruptions per year of £1.5m. Dividing this WTP by the average duration of an interruption, we obtain a WTP rate of about £5.4m per hour. Ofwat’s improvement would therefore be valued at £702,000.

Further reductions in the duration of interruptions beyond the proposed AMP6 target would require substantial investment in overland bypasses, cross connections and an increased number of isolating valves. To improve performance from the starting level of 0.294 hours to 0.20 hours, for example, would require capex of approximately £6.2m per annum (see Table W2a of our Business Plan resubmission, 27 June 2014). Comparing this figure to the WTP of £702,000 indicates that a target of 0.17 hours is not cost-beneficial for the AMP6 period.

**Discussion**

While we understand that Ofwat would like to see companies move towards upper quartile performance, our customers’ valuations suggest that it makes sense to work towards this improvement on a gradual basis. We therefore propose to achieve a PC of 0.24 hours at the end of the AMP6 period, and then a further reduction towards upper quartile performance over the following five years. In addition, because the interruption figure is quite volatile (subject to weather patterns and soil moisture deficit) we propose a deadband of ±0.05 hours that moves with the target except for the last year where we have removed the penalty deadband to ensure that we achieve the full scale of improvement by the end of the AMP6 period.

A gradual improvement in the PC over a longer period of time with a deadband has the following advantages:

• Reflects more closely that customers are not willing to pay for the improvement suggested by Ofwat - while Ofwat has not allowed the cost increase, the menu cost
sharing rate implies that customers are likely to pay 50% of any overspend. As a result, bills would rise if we have to meet the target of 0.17 hours in year 3.

- Minimises the risk of unintended consequences – we would be incentivised to find innovative ways of achieving the target and to learn from other companies. If the PC of 0.17 hours applies in year 3, we have insufficient time to consider, evaluate and implement the best solutions to achieve the target. However, achieving a 43% improvement in performance by the end of the AMP7 period (for example) would provide substantial incentive to innovate and work towards long-term sustainable solutions. We explain below why we need to consider our solutions carefully.

- Maximises the opportunity to deliver improvements within customers’ valuation – a longer time period would also give us more opportunities to find lower cost solutions so that customers are less likely to pay more than the value they put on the improvement.

We think that it is also worth noting by observation of the available data, that not all companies are interpreting the guidelines for measurement of this PC in the same way and therefore it may be difficult for some companies to converge towards upper quartile performance.

**Options for reducing the average time of an interruption over three hours**

We set out below the options we have considered for reducing the average time of an interruption. We also explain why these have not been introduced in the past, and why we had not planned to introduce them in the AMP6 period. Generally, these options have cost implications although it is acknowledged that in some instances, cost increases can be offset against reduced plant and labour costs if the duration of the event is shorter.

These options will have to be assessed carefully to ensure we achieve lowest cost improvements if we are to deliver a change in our performance.

The options for reducing the average time per property for interruptions include the following:

- **Smarter working.** This might include the use of overland bypasses, tanker infusions, and line-stopping techniques;
- **Temporary repairs** that allow a main to be recharged and then taken out of service again later for a permanent repair, in order to keep each interruption below three hours;
- **Making permanent changes to the network** in order to reduce the number of properties that would be affected by a supply interruption. This might include the insertion of more isolating valves or cross-connections between water supply zones;
- **Improving the network** by replacing more mains or laying additional mains to improve interconnectivity;
- **Reducing the amount of planned work** carried out.

Our views on the options for reducing the average time per property for interruptions are as follows:

- **Smarter working.** This might include the use of overland bypasses, tanker infusions and line-stopping techniques. Currently, we rarely use overland bypasses due to the high operational and water quality risk associated with them. The use of overland bypasses is considered when the risk can be mitigated and where it is appropriate and safe to do so. Due to the time taken and cost expended in installing them, we would not generally use overland bypasses for planned work (which is usually carried out overnight) unless
the interruption is likely to last longer than six hours. For shorter duration work, the time taken to put the bypass in place, including sterilisation, and ensuring water quality will not be compromised, does not justify the saving in the average time. Generally, we prefer to complete the work as quickly as possible. We will have to review this if Ofwat insist on imposing a tighter performance commitment.

In our view, the use of bypasses can seriously increase the risk of disturbing iron and chalk deposits resident in some parts of the distribution network, especially in the Sutton water resource zone, leading to increased risk of water quality failures and a lower standard of customer service. For more details of chalk deposits in the Sutton zone, see below.

For similar reasons, the Company does not use tanker infusions, or line stopping techniques.

- **Temporary repairs.** We do not agree with the use of temporary repairs as a means of keeping individual interruptions below the three hour target. The Company far prefers to effect a permanent repair at the first visit thus keeping the overall disruption to customers to a minimum e.g. an interruption of 2 hours followed by an hour break in-between where the customer’s supply is restored only to interrupt the water supply again for a further two hours to carry out a permanent repair, in the view of the Company, provides very poor customer service albeit achieving regulatory compliance through not having to report an interruption over 3 hours. In this example, we advocate a single 4 hour job with a “do it right first time” approach and an emphasis on keeping customer's inconvenience to a minimum. As already indicated, much of our planned work is carried out at night to minimise inconvenience to customers.

Temporary repairs are reserved for incidents where the Company may not have the right fittings to effect a permanent repair first time round.

The implication of the stringent nature of this measure is that it is likely to breed bad working practices and poor customer service.

- **Making permanent changes to, and improving the network.** Installing more isolating valves and cross-connections, or generally improving interconnectivity, to reduce the number of dead-legs and the number of properties that could be affected by a supply interruption, is clearly a desirable goal. However, we have not included for these kinds of network improvements in our AMP6 period totex. We would far prefer to invest in the programme of mains replacements that has been identified through its “common framework” analysis in order to avoid storing up problems for the future.

The Company has, since 1989, invested heavily in its ageing mains network resulting in a low level of leakage, and the lowest burst rate in the industry. A key philosophy is that the Company's capital programme has been designed to maintain the “stable” serviceability of its infrastructure network whilst avoiding increases in the average bill to customers. The Company has not included additional expenditure specifically to reduce the average time of interruptions to supply.

- **Reducing the amount of planned work carried out.** We could reduce the average time that properties are interrupted by carrying out less planned work, however, for the reasons set out in the paragraph above, we would far prefer to continue with our planned programme of mains replacements to avoid storing up problems for the future.

Much of the planned work which disrupts customers’ supplies is carried out at night in order to minimise the impact on customers. The Company could save money (and
invest in network improvements as described above) by carrying out this work during the
day. However, in the Company’s opinion this would be more disruptive to customers.
The Company chose not to distinguish between day and night working as this would
have complicated its ODI for interruptions. Ofwat’s proposed revised performance
commitment fails to recognise this.

Interdependence with other PCs: Stable serviceability
Our Business Plan expenditure is designed to maintain the serviceability of the network, not
to improve it (other than to provide additional mains for supply demand and resilience
purposes). We would therefore expect approximately the same number of supply
interruptions that we experienced in previous years. Our proposed performance commitment
is based on our average performance over the three years 2010 to 2013. A longer timeframe
to achieve upper quartile performance would therefore also give us more flexibility in aligning
the improvement in interruptions with serviceability.

Company-specific circumstances: Chalk in the Sutton zone
The Company has an agreement with the Drinking Water Inspectorate to manage operations
in its Sutton water resource zone to avoid disturbance of chalk deposits which are resident in
much of the water mains network. Due to the location and physical nature of the chalk, it is
not possible to flush these deposits out. Therefore, planned and unplanned work is carried
out in a way that minimises changes in flow, and the need for flow reversal. These
operations constrain options for reducing the number of properties affected by a supply
interruption. Managing the chalk in this way was accepted by Ofwat in its letter of 30 March
2007. It should be noted that these deposits are historic and are not being added to. The
agreement was reached due to the impracticality and prohibitive cost of clearing/replacing
the network in this area.

Disturbing deposits in the mains would inevitably lead to water quality failures, or extended
interruptions whilst the sediment was allowed to settle. As a result, it is crucial that we have
more time to consider how interruptions can be reduced without affecting water quality
failures.

Customer experience of interruptions
We believe that we are putting our customers first and causing minimum inconvenience by
carrying out night time operations. The level of work carried out at night, either as a Planned
and Warned interruption, or an Unplanned interruption that has been delayed until the night
is provided on the following tables. There is a marked difference between the amount of
interruptions carried out during the day and during the night which Ofwat’s revised
performance commitment does not recognise.

We have considered in more detail the aspects that affect the customer’s experience when
their supply is interrupted. The proposed performance commitment is designed to improve
service to customers, however, because it does not take all factors into account, it does not
necessarily achieve the best results. Two factors are important to distinguish:
• Unplanned versus planned interruptions – customers can plan ahead for planned
interruptions and therefore are likely to be less disturbed by these;
• Day versus night interruptions – night interruptions are less intrusive as the majority of
customers will not be affected.
We carry out the majority of our planned work at night to minimise disruption to traffic and the effect on those customers whose supply is interrupted. The table below confirms this. We are therefore strongly focused on minimising the impact of planned interruptions to customers as these are the component of this measure that we have most control over. Overall, more than 58% of the duration of interruptions above 3 hours was at night. This is not reflected in the performance commitment as the PC used by Ofwat applies a uniform rate across the industry regardless of the composition of interruptions.

<table>
<thead>
<tr>
<th>Year</th>
<th>DG3</th>
<th>No. of hours props interrupted &gt;3hrs per total no. of props</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Planned Day</td>
</tr>
<tr>
<td>2008/09</td>
<td>4.34</td>
<td>0.032</td>
</tr>
<tr>
<td>2009/10</td>
<td>0.17</td>
<td>0.012</td>
</tr>
<tr>
<td>2010/11</td>
<td>0.5</td>
<td>0.034</td>
</tr>
<tr>
<td>2011/12</td>
<td>0.42</td>
<td>0.011</td>
</tr>
<tr>
<td>2012/13</td>
<td>0.22</td>
<td>0.010</td>
</tr>
<tr>
<td>2013/14</td>
<td>0.49</td>
<td>0.011</td>
</tr>
</tbody>
</table>

*Significantly weighted by a single major burst main event

This would not be an issue if our target remained as we proposed. However, we believe a tighter performance commitment will cost us more and hence we may have to return to daytime working which is cheaper for us to carry out. Our view is that this will inconvenience customers more and will create greater traffic disruption. A longer time period to achieve the target would therefore allow us to consider how we can achieve upper quartile performance on the overall measure without shifting the duration of interruptions significantly between night and day or planned and unplanned.

In addition to considering the breakdown by day/night and planned/unplanned, it is important to consider the duration of our interruptions. As part of this representation, we have looked at the effect of changing the PC to interruptions greater than 4 hours, as one other company has done. The table below shows that a large proportion of the minutes of interruptions that affect customers are between 3 and 4 hours, generally, about 25%. The threshold of 3 hours...
is slightly arbitrary as it is not clear that customer’s valuations of interruptions increases significantly after 3 hours precisely. The table shows that our performance on interruptions above 4 hours is relatively good so a longer timeframe to achieve the upper quartile performance on the interruptions above 3 hours does not imply that customers do not receive a high quality service.

<table>
<thead>
<tr>
<th>Year</th>
<th>Interruptions greater than 3 hours</th>
<th>Interruptions greater than 4 hours</th>
<th>% of min between 3 and 4 hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008/09</td>
<td>0.948* (57 minutes)</td>
<td>0.796 (47 minutes)</td>
<td>16.0%</td>
</tr>
<tr>
<td>2009/10</td>
<td>0.204 (12.2 minutes)</td>
<td>0.147 (8.8 minutes)</td>
<td>28.0%</td>
</tr>
<tr>
<td>2010/11</td>
<td>0.474 (28.4 minutes)</td>
<td>0.342 (20.5 minutes)</td>
<td>27.9%</td>
</tr>
<tr>
<td>2011/12</td>
<td>0.162 (9.7 minutes)</td>
<td>0.126 (7.6 minutes)</td>
<td>22.3%</td>
</tr>
<tr>
<td>2012/13</td>
<td>0.252 (15.1 minutes)</td>
<td>0.159 (9.5 minutes)</td>
<td>37.2%</td>
</tr>
<tr>
<td>2013/14</td>
<td>0.224 (13.4 minutes)</td>
<td>0.170 (10.2 minutes)</td>
<td>24.2%</td>
</tr>
</tbody>
</table>

* significantly affected by a single major burst event

We are proud of both the amount and the quality of the data we have, going back many years, regarding supply interruptions. We have a well-established and documented process for recording and monitoring supply interruptions. We understand that customers do not want to be impacted by a supply interruption but they understand that it is sometimes necessary due to either planned or unplanned activities. We always keep the supply interruption to a minimum and where possible give information upfront to the customer. We are extremely concerned that changing this performance commitment as proposed by Ofwat will have a negative effect on both the Company and the customer.

Our proposal

If the Performance Commitment proposed in our revised Business Plan submission (June 2014) is not acceptable to Ofwat, then we propose the following, pragmatic and challenging, but achievable performance commitment which we consider overall would better represent the interests of our customers than Ofwat's proposed alternative. We are happy to discuss this further with Ofwat if required.

<table>
<thead>
<tr>
<th></th>
<th>Starting Level</th>
<th>Committed performance level</th>
</tr>
</thead>
<tbody>
<tr>
<td>PC</td>
<td>Hrs/prop</td>
<td>0.29</td>
</tr>
<tr>
<td>Penalty Collar</td>
<td>Hrs/prop</td>
<td>0.47</td>
</tr>
<tr>
<td>Penalty Deadband</td>
<td>Hrs/prop</td>
<td>0.33</td>
</tr>
<tr>
<td>Reward deadband</td>
<td>Hrs/prop</td>
<td>0.23</td>
</tr>
<tr>
<td>Reward Cap</td>
<td>Hrs/prop</td>
<td>0</td>
</tr>
</tbody>
</table>

Please note that no data is excluded in the calculation of our supply interruptions figures, and no caveats are applied to the performance commitment.
2.1.5. Performance commitment A4: Conditions and reliability of the mains network

Ofwat’s position

Ofwat has reduced the penalty deadband from 390 to 345 which is equivalent to halving the deadband.

Our position

We consider that our original deadband level of 390 was sufficient to protect customers from underperformance. Tightening the penalty deadband increases our risk of failure especially if we have cold winters. The totex included in our Business Plan is designed to maintain stable serviceability and not to improve the network or reduce the number of bursts. Notwithstanding the points made above, we consider the increased risk is manageable and are therefore prepared to accept Ofwat’s revised penalty deadband.

2.1.6. Performance commitment A5: Drinking Water Inspectorate’s Index of Water Quality

Ofwat’s position

Ofwat has tightened the penalty deadband from 99.93% to 99.94% in the first two years and to 99.96% in the last three years of the AMP period, and added a penalty collar. In addition, Ofwat has removed the statement that the level of 100 is a target not a performance commitment.

Our position

The changes to the penalty deadband increase the risk of the Company incurring a penalty. If the incentive was applied to the results for 2009 to 2013 (calendar year results) then we would have incurred a total penalty of £140k. Keeping our performance consistently within the revised deadband will be very difficult because it takes only a very small number of samples to fail for our performance to drop below 99.93. The majority of failures we have experienced in recent years are outside the Company’s control, having been caused by the condition of customer taps and/or plumbing (e.g. lead and nickel). See our compromise proposal below.

Discussion

While we think that there is already sufficient incentive for the Company to maintain the highest possible standard of water quality, we do not object strongly to the introduction of a penalty that punishes poor company performance.

Ofwat appears to be striving to bring all water companies to the same standard of performance irrespective of legacy issues and without a full appreciation of some of the reasons behind different levels of performance.

While the DWI index is generally designed to level the playing field, the contribution to the overall measure from some of the parameters monitored puts smaller companies in a position where a single failure will have a disproportionate impact on the overall index. While smaller water companies will find it easier to achieve 100% compliance, since overall they take fewer samples and are therefore at a lower risk of failure (UKWIR 11/RG/07/21), the impact of a single failure will be greater. In particular, the tests for a number of the plumbing metals, many of which are solely influenced by the condition of customer taps, are taken at a
low frequency per water supply zone, with little differentiation in frequency to account for zonal population. A single failure for nickel, which has nothing to do with the quality of the water supplied by the Company in our area of supply, and is beyond our control, will reduce our index by 0.02 due to the low number of water supply zones that we have. This was the case in 2013, where just two nickel failures and a single iron failure reduced the Company’s quality index to 99.96. If the two failures that were beyond our control had not been included in the index, we would have achieved >99.99%.

The following table shows our performance over the last five calendar years, how many regulatory sample failures there have been, and how many of those have been outside the Company’s control (i.e. investigations confirmed that the failures were attributable to the condition of customer taps and or plumbing).

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>DWI Index</td>
<td>99.92</td>
<td>99.99</td>
<td>99.96</td>
<td>100</td>
<td>99.96</td>
</tr>
<tr>
<td>Sample failures</td>
<td>15*</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Failures outside of our control</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>DWI index discounting failures outside of our control</td>
<td>99.93</td>
<td>&gt;99.99</td>
<td>100</td>
<td>100</td>
<td>&gt;99.99</td>
</tr>
</tbody>
</table>

* Principally pesticide failures including Metaldehyde.

Ofwat’s proposed tightened deadband also ignores the fact that it will be more difficult to achieve compliance from the current year on because of the change to the compliance standard for lead that was introduced in 2014. While we are not expecting a significant increase in the number of lead failures, the risk of sample failure will be higher than before 2014. As indicated above, lead is one of the parameters that has a big impact on our overall performance, due to the low sampling frequency. We estimate that close to 48% of our customers' supply pipes are lead, and results can also be affected by the inappropriate use of lead solder. The plumbosolvency of our water is controlled by dosing orthophosphoric acid – dosing was optimised a number of years ago to minimise lead failures. The only other realistic option we have for reducing the number of lead failures is to replace all our customers lead supply pipes – we have not allowed for this in our Totex programme since this approach would not have been justified or supported by DWI.

In addition to the impact of zonal size/number of water supply zones, there can also be a small impact from the variations in number of parameters that contribute to the DWI index. Some companies are assessed on 39 parameters, but some are assessed on a number between 39 and 35, where they have carried out a risk assessment in respect of the pesticides Aldrin, Dieldrin, Heptachlor and Heptachlor Epoxide and ceased to monitor these pesticides as part of their treated water compliance monitoring programme, with the agreement of DWI.

We opted to cease monitoring for these four pesticides in 2011 following a risk assessment and review of historic monitoring data. Reduced monitoring in line with risk assessment reduces the cost to our customers without compromising water quality, but the removal of four parameters that routinely achieved 100% compliance from the statistical determination of the index, can have an impact on the water quality index under certain circumstances. For our Company over the last five years, performance in 2011 would have been enhanced from
99.96 to 99.97% if we had monitored for all 39 parameters, and if we had not had the “dilution factor” from these high performing parameters in 2009, our recorded performance would have been 99.91% rather than 99.92%. The index is therefore not fully comparable across all companies under all circumstances, and whilst the impact of this minor change was acceptable when balanced with cost savings for the customer, it becomes a more significant factor when the Company may receive a financial penalty as a consequence of this decision.

We will continue to have an Undertaking for Metaldehyde throughout AMP6, as agreed with the DWI. While the Company has invested heavily in additional treatment and frequent carbon regeneration, and instigated catchment management and operational measures to reduce the amount of Metaldehyde abstracted, there is a residual risk of failure. The treatment installed is not effective against a persistent or high Metaldehyde concentration challenge, and we would find it difficult to guarantee compliance in a year of high water demand, or where the need to abstract water to satisfy demand, exceeds the wish to abstract water that does not contain Metaldehyde.

Our proposal
We do not consider that an onerous tightening of the penalty deadband is required to incentivise our performance in this area. However, in the spirit of compromise, we propose that the penalty deadband starts at 99.93% as per our Business Plan resubmission, and is tightened to 99.94 from 2018/19 (giving some time to review the effect of the new PCV for lead, and what might be done if the failure rate increases). A penalty collar is not required if the description of the penalty is correctly worded, however we have no objection to the introduction of a penalty collar of 0.01% points below the penalty deadband.

We request that our note “It should be noted that the level of 100 is a target, not a performance commitment.” be reinstated as we cannot commit to achieving 100% but we do not consider it appropriate to plan to fail.

2.1.7. Performance commitment A6: Taste, odour and discolouration

Ofwat’s position
Ofwat has amended the penalty collar from 600 to 500 and the reward cap from 100 to 200. The effect is to reduce the maximum penalty that can be charged and the maximum reward that can be earned.

Our position
We are uncertain as to why the collar and cap have been changed, but have no strong objection.

2.1.8. Performance commitment C2: Percentage of properties that are connected to more than one treatment works

Ofwat’s position
Ofwat has changed the penalty collar and introduced a reward deadband. Ofwat has also reduced the reward rate from £6.5k per percentage point to £5.2k.
Our position
We do not object to the change to the penalty collar, but suggest that this should apply across the last two years of the AMP6 period.
We propose that the original reward cap of 100% and reward rate of £6.5k per percentage point are reinstated.

Discussion
We do not understand the imposition of a reward cap and the reduction in the reward rate. The change means that there is no real incentive for the Company to look for different and innovative ways to improve resilience and increase the percentage number of properties connected to more than one treatment works.
As currently envisaged, the Company will have to lay additional reinforcement mains and increase the capacity of a number of booster pumping stations in the AMP6 and AMP7 periods in order to achieve 100% resilience (100% of properties connected to more than one treatment works). It is unlikely that a maximum reward of £52k will be sufficient to incentivise the Company to try to achieve any additional resilience above the AMP6 target.

Our proposal
We propose that the original reward cap of 100% and the reward rate of £6.5k per percentage improvement are reinstated.

2.1.9. Performance commitment E1: Level of leakage measured in megalitres per day

Ofwat position
Ofwat has increased the penalty collar from 25.4 Ml/day in 2015/16 and 25.0 in 2019/20 to 27 Ml/day in every year.

Our position
We do not object to the increase in the penalty collar, but question why this change is not two way. Why hasn’t the reward collar been lowered hence offering the opportunity for a larger reward?
See our proposal below.

Our proposal
Lower the reward cap to 22.4 Ml/d in 2015/16 and 22.0 Ml/d in 2019/20.

2.1.10. Performance commitment E2: Per capital consumption (PCC) measured in litres per head per day (l/h/d)

Ofwat's position
Ofwat has removed the proposed reward for this performance commitment and has omitted the link to our metering programme.

Our position
The reward and the link to our metering programme should be reinstated.
Discussion
Ofwat has removed our proposed rewards for this performance commitment as it considers the justification of the reward rate to be insufficient and more evidence on stretching performance is required.

Removing the reward has an impact on the risk and reward balance. Ofwat has indicated that it wants companies to be incentivised to improve their performance as its suggested RoRE range for rewards is above 1% (Ofwat, 2014, Risk and reward guidance). Removing the rewards for reducing per capita consumption reduces our RoRE range for rewards from 0.94% to 0.82%\(^1\). The reduction therefore reduces the scope of rewards that we can achieve. Without the reward, we have no incentive to increase the rate of metering which has an impact on PCC. We consider a reward to be appropriate to ensure that we are incentivised to exceed the PC.

To address Ofwat’s first point, we have re-considered the valuation of the incentive rate and the extent to which performance is stretching. While the relevant measure is PCC, the main way of achieving the reduction in PCC is to increase metering. In our Water Resources Management Plan and Business Plan we have planned to install 32,000 meters over the AMP6 period. Installing additional meters beyond this level within AMP6 would be a stretching performance as this would require a step-up in investment. In principle, this is in customers’ interests as greater metering has a number of benefits such as deferring the need for developing additional water sources and therefore minimising the impact on the environment.

We therefore consider there should be a reward rate which encourages us to increase metering beyond the 32,000 meters already included in the Plan. The average incremental costs of reducing demand by 1 Ml/day/year is £146,545. This is in line with our Water Resources Management Plan which also states that 1 l/pr/day is equivalent to 0.27 Ml/day in total across the company area or 0.4 litres/head/day. This suggests that the cost for reducing PCC by 1 l/h/d is c. £100,000. Applying a 50% cost sharing rate would lead to a reward rate of £50,000 per l/h/d which is higher than the rate based on greenhouse gas emissions (£32,000) but still substantially lower than the penalty rate of £71,400 per l/h/d.

To ensure that performance is stretching, we propose that the rewards should only be paid if we demonstrate that we have exceeded our metering programme. Therefore, the reward would only apply after we have installed 32,000 additional meters.

Ofwat has also removed the link to the AMP6 metering programme. This makes this PC inviable. PCC is extremely volatile (see the variation over the last five years in the table below). PCC can vary by +10% in a dry year, and -5% in a wet year. Five years is too short a period to expect convergence to a long term average. The purpose of this PC is to ensure that metering is carried out in accordance with the proposed programme, and only to penalise the Company if this is not the case and average PCC does not fall at the expected rate. Similarly, if the Company is able to invest more in metering, that this is rewarded if average PCC falls below the forecast rate.

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\(^1\) Not accounting for other changes made by Ofwat.
### Average per capita consumption in l/h/d

<table>
<thead>
<tr>
<th>Year</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average per capita consumption in l/h/d</td>
<td>166.8</td>
<td>171.9</td>
<td>168.6</td>
<td>161.4</td>
<td>166.5</td>
</tr>
</tbody>
</table>

**Our proposal**

We propose that the reward, and reward deadband and cap, and the link to the AMP6 metering programme, are reinstated, and the reward rate is revised to £50,000 per l/h/d as set out above.

### Wholesale cost assessment – cost exclusions

#### 2.2.1. Introduction

In our PR2014 Business Plan resubmission, we made the case for four wholesale cost exclusions as follows:

- Softening
- Average pumping head
- Street works
- Pension deficit

We have accepted Ofwat’s position on Softening and Pension Deficit. Our representation, which has been discussed and formulated with the help of our economic consultants, Frontier Economics, therefore concentrates on our arguments for Average Pumping Head and Street Works.

#### 2.2.2. Average pumping head

**Summary of business plan position**

We claimed a cost exclusion of £5.3m relating to average pumping head that is above the industry average. Ofwat accepted the basis for the claim and made an allowance of £2.0m.

**Our circumstances**

The majority of our water (85%) has to be pumped from well below ground level (i.e. from boreholes) to the higher points in our area of supply, in particular the top of the North Downs and Greensand ridge, where most of SESW’s service reservoirs are located. This means we have one of the highest average pumping heads in England and Wales – 195 m in 2012/13 compared to the industry average of 136m. The graph below shows our pumping head against the industry minimum, maximum and average based on information from June returns and the August 2013 PR 14 submission.
Higher pumping heads mean power costs are a higher proportion of our total operating costs. While we ensure that our power usage is as efficient as possible, we have one of the highest energy consumptions per million litres of water. Our power costs have historically comprised a higher proportion of our wholesale totex than other companies. Ofwat’s own analysis indicates that our power costs are 3.3% above the industry average.

**Our estimate of the cost exclusion**

Only one out of the three main totex models – the full COLS totex model – includes average pumping head in its specification. This means that only one-third of the impact of average pumping head on our cost base is taken into account by Ofwat’s models.

To quantify the extent to which Ofwat’s model underestimated the impact of average pumping head, we have replaced the Company’s pumping head explanatory variable (196.68 m.hd) with the industry average for 2012/13 (136.18 m.hd) and observed how the totex forecast by the full COLS model changes. This substitution makes the full totex COLS model analogous to the other models which, by not including pumping head as an exogenous variable, implicitly assume an industry-average relationship.

After making the substitution, the results of the full totex COLS model show that forecast totex decreases by £8.5m (from £194.0m to £185.5m). After applying the 6.53% adjustment for upper quartile efficiency the change in totex forecast is £7.94m.

However, as noted above, this effect is not fully captured in the totex threshold calculation because the full totex COLS model only accounts for a third of the final result. To see this, we have made the same exogenous variable substitution and considered the change in forecast totex across all three models. The change is a reduction in the totex baseline of £2.64m, a third of the impact calculated above.

This means that, by having a variable for average pumping head in only one of the three models, Ofwat’s models underestimate the impact of our average pumping head by £5.30m (i.e. the remaining two thirds).
Ofwat method at Draft Determination

Ofwat’s approach also focusses on the bottom-up and the refined totex approaches that do not include an explanatory factor for average pumping head.

- **Bottom-up modelling:** This approach gives the Company a Basic Cost Threshold of £215m. This is substantially higher than the allowance from the full totex stream (£181m), and on this basis Ofwat does consider that the models in this stream require a further uplift to allow for energy costs.

- **Refined totex modelling:** The refined totex models give the Company a lower allowance than the full model. Ofwat accept that this is due to the fact that the refined models do not use pumping head (proxy for company-specific energy costs) but rather make an average power cost allowance.

Ofwat does not fully accept our method for estimating the cost exclusion of this model. Ofwat’s approach focuses on the fact that full totex model gives companies the same unit cost and a specific pumping head. The refined gives them an average power bill (pumping head x unit cost) implicitly. So the difference between the two is not just down to the pumping head variable. The refined might thus be giving a higher unit cost than the Company actually has (as part of the power bill), which would mean that the required uplift of the refined totex might be lower than the Company estimates.

Ofwat’s calculation of the adjustment is the following. The full totex allows £181m while the refined gives the Company £159m. The Company’s power bill as proportion of totex is 3.3% higher than for an average company. Taking 3.3% x 181 = £6.019m gives the additional allowance in the full model compared to the industry average. The refined model is based on industry average power bills (so covers the 8.3%) but is missing the £6.019m. In terms of BCT, Ofwat divides by 3 and get an adjustment of £2.006m.

Assessment of Ofwat’s Draft Determination method

We have two concerns relating to Ofwat’s method.

- **No allowance in bottom-up modelling**
  The fact that the bottom-up model results in a higher Basic Cost Threshold than the full model does not provide a sufficient reason to not include an allowance for average pumping head. It appears to imply that the full model is the ‘correct’ one and therefore a model which predicts a higher cost automatically does not qualify for a cost exclusion.
  This interpretation does appear to be correct or consistent with Ofwat’s overall position for the modelling. Ofwat’s approach is to treat the three modelling approaches as equally valid. On this basis there is one model that includes pumping head as a cost driver and two that do not. It does not appear to be valid to distinguish between the two models that do not include pumping head on the basis of the predicted costs for the Company.
  To put it another way. The bottom-up models imply a higher cost threshold for the Company based on cost drivers excluding pumping head. There is no basis for saying that this implies that there is an implicit allowance for higher pumping head with the model. It is entirely possible that this model is taking a different (but valid) view on the impact of the other cost drivers on the Company’s costs.
• **Method removes benefit of lower unit costs**
The Ofwat method of calculation makes an adjustment to reflect the fact that the Company's unit costs of power are lower than the industry average. This appears to be an unnecessary adjustment as genuine differences in unit costs are part of the efficiency that the models are trying to estimate. As a result it is unfair to scale back the cost exclusion for a legitimate factor outside of management control (i.e. higher average pumping head) due to the fact that the company has achieved below average unit power costs.

**Summary of response**
For the reasons outlined above we consider that the cost exclusion estimate of £5.3m is the appropriate value of the additional costs associated with higher pumping head that are not captured in the modelling approaches.

### 2.2.3. Streetworks

**Ofwat’s position**
Ofwat has rejected the Company’s claim for additional street works costs arising out of the introduction of permits. Ofwat states that this is because these street works costs are included in the historic costs used by the models, and that any regional differences are dealt with by an allowance within the models for regional variations in costs (in 2012/13).

**Our position**
We agree that the models are designed to, and therefore should capture regional differences in construction costs. At the same time we have two concerns that the allowance for regional cost differences will not cover the additional street works costs that we face:
- first, the BCIS regional cost index covers general construction and therefore will not fully capture the impact of street works; and
- second, our street works costs have substantially increased in recent years and this is not captured in the regional cost factor.

**Regional cost adjustment**
The regional cost adjustment in Ofwat’s model is based on the BCIS construction index. This covers a broad range of civil engineering and construction activities. The vast majority of these activities will not incur significant costs associated with street works. Street works costs are only incurred by utility companies and these make up only a small proportion of the construction activity in the BCIS index. Therefore, any regional differences in the impact of street works would not be properly reflected in the BCIS regional indices.

Concern about applying the BCIS dataset to utilities has been identified by CEPA, Ofwat’s advisers on cost modelling, in work undertaken for the Utility Regulator for Northern Ireland. They stated.

“The BCIS data was used as reference by Ofwat in its recent price determinations. The BCIS dataset is constructed from real tender price information and includes estimates for regional price differences. However, the BCIS data suffers from the same limitation as any dataset that attempts to derive regional prices from observed data: The smaller the region – primarily in population terms – the fewer observations will be available in any given timeframe. This means that particular types of building...
projects could be dominant in an observation period, while others are missing completely. This type of issue can severely skew the sample and make the derived estimates less reliable and difficult to interpret. The problem is particularly severe when looking at a specific sector, such as water and sewerage, which has a different cost structure from other construction activities.”

“Ofwat used the BCIS Location factors, which are based on tender information. The BCIS Location factors cover a wide range of construction and civil engineering work and are therefore not specific to the water industry.”

Increase in our street works cost since 2012/13
The latest regional cost data in the Ofwat modelling relates to 2012/13. The Ofwat cost assessment acknowledges that the Regional BCIS Index would not reflect changes in regional costs within the time period “This variable should not capture changes over time.” The issue that we face is that our street works costs have increased significantly since 12/13.

The Surrey Permit scheme was introduced from 11 November 2013, covering all roads except motorways and trunk roads. By 11 November 2013 100% of our supply area was covered by permit schemes.

The financial impact of this was set out in our Business Plan Resubmission (June 2014) and is clearly demonstrated on the chart in Appendix 9 of this document.

In addition, in June 2012 (TFL) and May 2013 (Kent CC), the only two lane rental schemes in operation in England and Wales were introduced into our area of supply under Section 74A of the New Roads and Street Works Act. We have not included these costs in our cost exclusion claim because they are relatively small at this time. However, for information, our lane rental costs to date are summarised on the following table.

<table>
<thead>
<tr>
<th></th>
<th>2012/13</th>
<th>2013/14</th>
<th>2014/15 To date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lane rental costs</td>
<td>£4.0k</td>
<td>£9.8k</td>
<td>£9.9k</td>
</tr>
</tbody>
</table>

Permit data
The graphs included in Appendix 9 to this submission show:
- the extent of permit schemes in London Boroughs;
- the impact of permit costs on Sutton and East Surrey Water (previously included in “Supporting Document L” of the June resubmission – this shows that there was an increase in the last quarter of 12/13 but there most significant increase has occurred since then – the costs in Jan-Mar 2014 are over 500% higher than the average costs for 2012/13; and
- our work patterns for mains laid and other mains jobs to demonstrate that our work pattern has been relatively steady compared to the increase cost of permits.

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2 CEPA, Regional price Adjustments, Report for the Utility Regulator, 7 March 2014.
**Summary**

The evidence we are presenting is to demonstrate that we do not think the allowances within the models, particularly the model which aims to represent regional variations, accurately reflect the additional costs of permitting that we will have to bear in the AMP6 period.

As set out in our June resubmission, we believe this wholesale cost exclusion claim fulfils Ofwat’s criteria set out in the pre-qualification decision because:

- there is compelling evidence of the need for the programme;
- it is justified by cost benefit analysis and strategic optioneering;
- there is robust evidence on costs; and
- the interests of customers will be properly protected.

### 2.3. Allowed Returns

#### 2.3.1. The Issue

The Company’s 27 June Business Plan Resubmission included an uplift of 0.5% to the 3.7% industry wide allowed Weighted Average Cost of Capital (WACC) for Wholesale activities. This was supported by:

- Strong evidence from respected independent technical experts (OXERA and Frontier Economics) and close Board engagement that the cost of financing a smaller Water Only Company existed, and could be reliably estimated at a level significantly above 0.5%. The uplift claimed was a conservative estimate of an observable reality.
- Strong economic evidence that the benefits to customers of the water industry in general far exceeded the costs incurred by allowing the justified uplift; and
- Compelling evidence of customer support for allowing the uplift, based on research techniques designed and applied by leading customer research experts (Accent) which were reviewed and supported by the Company’s independent Customer Challenge Group (CCG).

Whilst the latter two sets of evidence were new requirements introduced by Ofwat in January 2014’s “Risk and Reward Guidance”, and were not consistent with either regulatory precedent or previous interpretations of the statutory duty to ensure that efficient companies were able to finance their functions, the Company complied with the change in methodology in good faith and in the interests of securing a determination of price limits which satisfied the regulator’s as well as companies’ and customers’ priorities.

The approach adopted in the Draft Determinations accepts that there is a higher cost of debt financing for the smaller (water only) companies and, based on work undertaken by PWC, estimates the efficient cost is equivalent to 25 basis points on the cost of debt or 15 basis points on the wholesale cost of capital. The Draft Determination therefore confirms that the Company passes Ofwat’s first test for securing an uplift to the industry wide allowed cost of capital.

However, the Draft Determination ignores or dismisses on unclear grounds much of the additional evidence already supplied and:
Fails to acknowledge the strong evidence that there is also a higher cost of equity for smaller companies
• Applies tests to determining benefits to customers that are unjustifiably narrow in their scope and flawed in their application.

The Company reaches these conclusions on the basis of an independent expert technical review of the approach undertaken for the Company by Frontier Economics, who have supported the Company and others in previous referrals to the Competition Commission. The Board therefore has full confidence in the merit of the arguments advanced. The Frontier Economic report is enclosed with these representations at Appendix 2.

2.3.2. Further Evidence
Premium on the Cost of Equity
Compelling evidence that a premium on the cost of equity exists for a smaller company has already been provided in the Company’s original Business Plan submission in December 2013, and is not repeated here. However, there are three aspects of the approach adopted in Draft Determinations that need challenging to avoid being accepted on the basis that they have not been challenged.

First, there is strong regulatory precedent – from both Ofwat itself and from the Competition Commission – that there is a premium to the cost of equity for smaller companies. At PR09 Ofwat addressed this through assuming a lower gearing with no change to the cost of equity for the smaller water only companies. This was de facto recognition of a higher asset beta and a premium to the cost of equity. This approach was recognised and reinforced by the Competition Commission in its report on the Bristol Water appeal in 2010. This is clearly contrary to PWC’s conclusion - upon which Ofwat rely for the Draft Determinations – that Ofwat did not intend to apply a cost of equity adjustment for smaller companies at PR09.

Secondly, arguments put forward for discounting the unavoidable impact of higher operational gearing for smaller companies are flawed. Choices over PAYG and RCV run-off rates have trivial impacts on the balance between RCV and revenues/expenditure in AMP6, and indeed would need to be applied to extreme levels over multiple price control periods to remove the differences currently existing. The assertion that a systematic risk from higher levels of operational gearing implies a negative equity beta lacks evidence or a sound theoretical basis, as the Frontier Economic report exposes. Suggestions that revenue correction mechanisms remove systematic risks fail on the basis that there are demonstrable generic risks that are not eliminated by such correction mechanisms.

Thirdly, PWC refer to evidence from the quoted share price of the Dee Valley Group to demonstrate that there is no systematic difference in market perceptions of betas for smaller water companies. However, market data for the Dee Valley Group is unreliable due to the infrequent trading and change in its share price, and has as a consequence been discounted as a reliable indicator in all previous price reviews. Moreover, the Frontier Economics report demonstrates that the application of sophisticated statistical techniques cannot properly mitigate the intrinsic flaws with this data.
Sutton and East Surrey Water

Representation to Draft Determination

Is the Customer Benefit Test Appropriate?
Having accepted that there is a higher efficient cost of financing for smaller companies (even if only for the cost of debt), failing to recognise this in allowed revenue is not compatible with Ofwat’s statutory duty to ensure that an efficient company is able to finance its functions. Effectively, the rate of return is being set below the accepted cost of capital, which runs counter to the conclusion reached by the Competition Commission. Having accepted that the higher financing costs are not the result of any inefficiency on the part of smaller companies, there is no basis for the adoption of an additional test – customer benefit – in order to justify inclusion of an uplift into allowed prices.

The Application of the Customer Benefit Test is Flawed
The Frontier Economic report highlights a series of material flaws in the way in which Ofwat have applied the customer benefit test, correction of any one of which would change the balance between the costs of allowing an uplift to the WACC for the Company and the benefits enjoyed by customers in general. In particular:

- Making a more realistic assumption about the probability of a merger occurring – and a comparator being lost – would increase customer benefits threefold
- Assuming “negative benefits” (i.e.- costs) to customers from the loss of a company that is not in the upper quartile for totex efficiency is artificial and unrealistic – applying a more common and reliable approach (using an independent benchmark), in combination with a more realistic assumption about the probability of mergers occurring would generate customer benefits of over four times the cost of allowing a debt premium
- Claiming that the additional points available from multiple year data for companies eliminates the cost to customers from a loss of precision in benchmarking techniques is shown to be false by the Frontier Economic analysis – thereby ignoring benefits from the Company as a comparator worth between £47m and £95m over 30 years – far more than the cost of an uplift to the WACC
- The totex benchmarking itself is flawed because it fails to properly account for the whole of the additional pumping head and higher street works permit costs incurred by the Company (as addressed in section 2.2 above)
- Ignoring benefits from other comparators, including for outcome delivery incentives and the associated target performance commitments, is inconsistent with the horizontal benchmarking used to establish upper quartile targets for performance commitments in Draft Determinations, which Ofwat claims is aimed at delivering benefits customers value. If horizontal benchmarking for performance commitments is retained in Final Determinations, the benefit to customers must be incorporated into the benefits provided by smaller companies as an offset to an allowed higher cost of capital.

If the customer benefit test is therefore to be retained in Final Determinations, it needs substantial modification to be robust enough to stand up to challenge. The modifications summarised above would clearly demonstrate that the benefits of smaller companies to customers in general far outweigh the costs of a WACC premium, which ought therefore to be allowed.
2.3.3. Unequivocal Customer Support

A fundamental tenant of the new approach to setting price limits at PR14 has always been to put the customer much more squarely at the heart of the process, and to arrive at settlements that more accurately reflect customers’ stated opinions and preferences. The Company has embraced this philosophy wholeheartedly and undertaken extensive customer consultation, including detailed and constructive engagement through the Customer Challenge Group. The Company’s Business Plan is richer and more strongly anchored in customers’ priorities than ever before.

One of the unanticipated benefits of the challenge posed by the customer benefit test introduced by January’s Risk and Reward Guidance has been the quality and strength of the insight into the way in which customers think about – and value – being served by a small, local company. The evidence was scrutinised in detail by the Board, who placed great weight on the unequivocal insight into customer values revealed by the focus group discussions. The research was also scrutinised by the CCG. The full findings, provided by Accent, we included in the 27th June Business Plan resubmission.

The Board therefore found the dismissal of the clear views of customers on the grounds that participants were “only provided …. with limited information which may not have been understood by customers” as completely contrary to one of the central tenets of the PR14 process that the Company has strongly supported.

Accent has responded to the comments from Ofwat stating “The evidence provided to Sutton and East Surrey Water regarding Small Company Premium is based on a series of four focus groups conducted in May 2014 which invited a full range of customers (younger/older; low SEG/high SEG) to give their views. A qualitative methodology was deliberately selected as it afforded the opportunity to take customers through the topic very carefully, in a step-by-step manner, to ensure comprehension of what is a less than straightforward concept.

The overall design of the sessions was to start with discussion of perceptions about SESW and talk about fundamental concepts such as what does ‘small’ and ‘local’ mean and what are the associated advantages and disadvantages. This approach was deliberately taken to introduce the topic in a gentle manner and to get an understanding of broader views before moving on to discuss the details of what the small company premium bill impact would mean. The areas of discussion were designed in close co-operation with SESW and were then reviewed and approved by the CCG and CC Water.”

It is also worth mentioning that Ofwat was given the opportunity to comment on the structure of the research but declined.

Extracts from the unequivocal evidence are repeated below as a sign of the importance the Board attaches to the views of the Company’s customers and in the hope that they will be accorded the same seriousness by a regulator with a statutory duty to protect the interests of customers.

“Respondents welcomed that there was no need to think about SESW. There was a belief that they had no reason to switch from or engage with the organisation. Respondents had
had limited reasons for contacting the Company. Those who had made contact were highly satisfied with their experience – any issue was resolved within an acceptable timeframe/manner”.

“Respondents across all four groups understood why the Small Company Premium (SCP) was in place. On the whole it was considered to be a fair principle and one that they accepted. The current level of SCP, of £4, was felt to be insignificant in terms of the overall bill size and all respondents were happy to pay this in order to maintain the size/status of their water supplier”.

“There were no respondents in support of any merger and only three were neutral to the prospect. They were particularly keen to guard against any deterioration in customer service and maintain the accountability provided by small and local company”.

“Support for a merger was only given if substantial bill reductions were offered – for most respondents this would mean a £50 reduction. Nevertheless, a small number would accept a merger for a £30 reduction.”

2.3.4. Company Proposal
The Company remains committed to securing a Final Determination that is acceptable to all stakeholders in the round and, whilst disagreeing fundamentally with some aspects of the assessment of the WACC appropriate to a small company, is prepared to accept a smaller premium than was included in its Business Plan Resubmission as a means to achieving this. The Company therefore makes a representation that an uplift of 15 bps, equivalent to that provisionally included in the Draft Determinations for Sembcorp Bournemouth Water and Portsmouth Water, be included in the Final Determination for Sutton and East Surrey Water. This has therefore been included in the financeability assessment for the Company discussed under the Appointed Business section of these representations.

2.4. Uncertainty mechanisms
2.4.1. Water business rates
Ofwat has included a 75%:25% uncertainty mechanism for all companies consistent with its prior guidance and earlier draft determinations. We accept the inclusion of this mechanism.

2.4.2. Water framework directive
Ofwat’s position
Ofwat does not accept the need for an uncertainty mechanism in this area, as the potential spending involved is too small for this risk to be material, as Sutton and East Surrey Water has substantial opportunities to mitigate the impact of this risk should it arise, and Sutton and East Surrey Water has not provided adequate justification why it is in a different position to all other companies which would face substantially similar risks with regard to the Water Framework Directive.

Discussion
We are concerned that Ofwat may have misunderstood our concerns.
As set out in our original Business Plan (December 2013), we are required to carry out a number of NEP investigations for water resources in the AMP6 period which could lead to sustainability reductions. Of particular concern are sources in the North Downs Chalk associated with the River Wandle. Licences to be investigated amount to around 50 Ml/d. The investigations for these licences are due for completion in 2017. It is therefore feasible that we could be subject to sustainability reductions in the AMP6 period for which we would have to make alternative provision. We are simply asking for a true-up mechanism that would allow us the cost of making that alternative provision.

Materiality
We would only be allowed to recover the cost if the value exceeded the materiality threshold and the work had to be carried out in the AMP6 period.

Controllability
We fail to understand Ofwat’s point about control of the cost of the project. It is the uncertainty, and the potential size of the project that are of concern. We would not embark on a large water resources project without discussion with the Environment Agency and Ofwat, and would only seek reimbursement if all parties agreed the project was necessary, and had to be carried out in the AMP6 period. The cost of the project would be agreed at the start.

Comparability with other companies
We cannot comment on why we are in a different position to other companies. We assume this is because other companies are already more certain of their position on likely sustainability reductions, or the potential size of any such reductions is not material.

Our position
We are simply requesting that a mechanism is in place (we have suggested a true-up mechanism similar to logging-up) which allows the cost of any material project arising out of the Water Framework Directive to be taken into account at the next review without being penalised by the totex menu.

Our proposed true-up mechanism is intended to put customers into the same position they would have been had a similar material project been required at the start of the AMP7 period (as part of the PR2019 Business Plan).

2.4.3. The Open Water programme
Ofwat has chosen not to support our proposed true-up mechanism. We have chosen not to pursue this uncertainty mechanism.

2.5. Service standard outputs
Ofwat document “Setting price controls for 2015-20. Draft price control determination notice: technical appendix A3 – wholesale water and wastewater” section A3.6.6 – service standard outputs, requires companies to provide information on service standard outputs as part of their draft determination representations.
Our PR2009 Final Determination, section 2.4.2 Resilience, table 2.4.2, identified two projects as service level outputs, as follows:

- Woodmansterne water treatment works: protection of 24,000 properties from risk of loss of supply as a result of flooding; and
- Kenley water treatment works: protection of 34,000 properties from risk of loss of supply as a result of flooding.

With reference to Anthony Ferrar’s email to Cathryn Ross of 7 March 2014, and to our SEMD Certifier’s report to Ofwat of March 2014, work at Kenley was delayed by flooding due to the exceptionally intense winter rainfall. We confirm that work at this site was completed in the summer of 2014 following a review of the events of February 2014 and that consumers are adequately protected.

It should be noted that despite the exceptionally high winter rainfall, and the flooding that affected the Caterham Bourne Valley, supplies of high quality drinking water were maintained to over 40,000 customers.
3. **Household retail**

3.1. **Introduction**

Ofwat's Draft Determination for Household Retail allows insufficient revenue for the effective carrying out of the Company's obligations because:

- Allowed revenue for the five years is in aggregate 24.4% lower than the Company's Plan; and
- Annual allowed revenue falls by 14% over the five years (from £5.6m in 2015/16 to £4.8m in 2019/20), despite the number of customers increasing by 3.6%.

There are two principal reasons for this unsustainable position:

- The divergence between Ofwat's methodology for determining an Allowed Cost to Serve for metered customers and the Company's cost allocation, which results in a 29% reduction in the Allowed Cost to Serve per metered customer over the five year period; and
- No allowance has been made for the unavoidable impact of external price pressures (principally wage inflation), even after proposed efficiencies have been taken into account.

The Company is therefore making representations on both issues, with a view to arriving at sustainable allowances in the Final Determination.

Specific information on cost allocations requested in the Draft Determination is also covered in part 3 of this section of our representations.

3.2. **Allowed Cost to Serve**

3.2.1. **The Issue**

The Draft Determination provides for the Company's proposed Cost to Serve for unmetered single service customers in full and comments that "the company is upper quartile efficient for unmetered household retail costs, but not for the additional costs of metering". In fact the Company's proposed metered cost to serve over AMP6 averages £26.36, compared with an industry average cost to serve for metered water only customers of £26.78 (as quoted in the Draft Determination). In effect, the Company's proposed metered cost to serve is in line with the industry average, in contrast to the upper quartile efficiency assessment for the unmetered cost to serve.

However, the methodology for determining allowances for metered cost to serve simply adds an allowance for the additional costs of metering to the allowed costs for unmetered customers. The additional allowance is determined separately from the unmetered costs to serve allowance, by calculating an industry average increment for metering and adding this to the company specific allowed cost to serve for unmetered customers. This has resulted in an allowed cost to serve for metered customers that is neither logical nor sustainable in the circumstances faced by the Company because it:

- Combines an upper quartile efficient allowance for unmetered customers, with an industry average increment for metered customers; and
- Penalises the Company for having a higher than average increment for the cost of metering.
The effect relative to the Company’s proposed allowance and the average allowances included in the other Draft Determinations published at the end of August is shown below.

The Company has therefore considered options for achieving a sustainable allowance within the mechanics of the methodology applied in Draft Determinations and has concluded that a revision to the allocation of Retail costs between unmetered and metered customers is necessary and acceptable. The evidence to support a revised allocation is set out in this representation.

3.2.2. Proposed Solution

The allocation of household Retail costs to the additional costs of metering in the Company’s original Business Plan and the June 27th Resubmission was based on the allocation adopted for many years for charging purposes. More specifically, the incremental cost for each metered customer reflected the additional costs of metering included in the differential target for combined (Wholesale and Retail) charges to customers as applied each year in determining charges under the Principal Statement. The target itself was modified to reflect the costs (principally relating to the installation of the meter itself) that now form part of Wholesale costs.

This approach was adopted for three main reasons:

1. It reflected the way in which current charges are set, and was therefore least likely to generate unforeseen and unwanted incidence effects;
2. It reflected Ofwat guidance for charging purposes in an area where true incremental costs had been debated for many years and a settled position arrived at; and
3. Whilst some components of the additional cost of metering are easy to establish (meter reading costs, for example), judgements are required for many other areas (including the additional propensity of metered customers to query bills and payment arrangements) and the range of reasonable judgements is quite wide and likely to lead to variations in approach.
However, it is clear from the information now available from Draft Determinations that this approach generates an increment for metered customers that is significantly higher than that for virtually all other companies. The Company has therefore revisited the incremental cost of serving a metered customer by undertaking a line-by-line review of Retail costs to determine:

- which combinations of expense type and activity are entirely attributable only to metering activities and which are only partly so; and
- for those activities in part attributable to metering, what is an appropriate cost driver for allocating costs between metered and unmetered.

This results in a much lower allocation of costs to metering, with a commensurate increase in the allocation to unmetered activities (which in reality apply to both metered and unmetered customers). The revised Table R3 included as Appendix 4 shows an incremental cost of metering for household Retail activities of £863k, the equivalent of £7.71 per customer, still above the industry average but clearly less of an outlier. This has been rolled forward through AMP6 based on the specific cost increments included in our Business Plan that are solely attributable to metering – additional meter reading and contact handling resources that would not be needed were it not for the increasing number of metered household customers. Nevertheless, after applying the efficiencies implicit in the Company's Plan, the incremental cost of metering falls to £6-87 by 2015/16 and to £6-46 by 2019/20.

The Company has commissioned work from its independent reviewer (Peter Martin of Black and Veatch) to provide independent assurance on this revised allocation. His report – which also covers the information provided in response to the specific cost allocation queries raised in the Draft Determination – is included as Appendix 7 to this representation. The report concludes “that the data and methodology used by SESW to calculate the incremental cost of serving a metered customer are appropriate and have been applied in a consistent and pragmatic manner such that the overall cost computed is a true reflection of SESW’s total additional costs of serving metered household customers.”

The revised Table R3 included as Appendix 4 also incorporates:

- An updated allowance for input price pressures beyond management control, described in section 2 below
- Adjustments arising from the cost allocation queries addressed in section 3 below

The net effect of these two sets of adjustments - together with the impact of the revised allocation to unmetered cost to serve as a consequence of revisions to the additional cost to serve for metered customers - is to increase the Company Cost to Serve for an unmetered single service customer to £18-78 in 2013/14. Over AMP6, the unmetered single service cost to serve rises from £18-06 in 2015/16 to £19-14 in 2019/20, largely due to the impact of price pressures beyond management control. Whilst no longer upper quartile, these cost to serve figures are still below the industry average cost to serve and should therefore be allowed in full.

**3.3. Input Price Pressures**

**3.3.1. The Issue**

The Company’s 27 June Business Plan Resubmission included a proposed allowance for the net impact of input price pressures (primarily related to wage inflation) amounting to £4.0m
over the AMP6 period. This was based on a detailed bottom-up estimate of inflationary pressures for the mix of costs incurred in the Company’s Retail function and an estimate of the efficiencies (both frontier and catch-up) that the Company might reasonably achieve.

The Draft Determination considered the Company claim was material enough to merit testing in accordance with the criteria specified in the Methodology for determining allowed Retail costs, and concluded that the approach adopted for determining the size of the adjustment was appropriate and reasonable. Moreover, the assessment of the Company’s unmetered cost to serve as upper quartile efficient (although not the additional costs of metering), meant that it was not reasonable to assume that input price pressures could be absorbed and they should therefore be allowed to be passed on to customers through an adjustment to the Cost-to-Serve allowance that would not be linked to future inflation.

However, the claim was nevertheless rejected on the grounds that the Company had not provided satisfactory and convincing evidence that:

- future cost increases affected the Company more materially than other companies;
- management practices demonstrated that the Company manages its costs to the extent that future cost increases are outside efficient management control; and
- it was efficient relative to comparators outside the water industry.

The Company has therefore assembled additional evidence – based on a new report commissioned from Economic Insight – to address these challenges. The full report forms Appendix 3 to these representations.

Economic Insight have endorsed the approach adopted in the Company’s Business Plan to claim only for the cost pressure that is outside management control and impacts the Company more materially than other companies. Their work includes:

- confirmation that the estimate of gross input price pressure identified by the Company – and accepted in the Draft Determination – is indeed reasonable and robust;
- benchmarking within the industry and with comparators from other industries, to determine appropriate “catch-up efficiency” challenges that the Company should aim to achieve; and
- confirmation that the general productivity/frontier shift assumed in the Company’s Business Plan was reasonable and soundly based.
The approach is illustrated conceptually in the Figure below:

![Diagram showing gross input price pressure, net input price pressure adjustment, productivity/frontier shift, and catch up efficiency](source: Economic Insight)

In addition, the report provides comprehensive evidence of the existing management practices used to mitigate the impact of inflationary pressures on Retail costs.

Principally as a result of adopting more aggressive catch-up efficiency factors (based on the comprehensive benchmarking evidence assembled), the Company proposes to reduce its claim for an allowance for input price pressures over the AMP6 period from the £4.0m included in its Business Plan to £2.8m. This revised claim has been included in the updated table R3 at Appendix 4. The key areas of additional evidence are summarised in this overview.

### 3.3.2. Benchmarking to Determine Catch Up Factors

Benchmarking within the industry – and with other industries – can be undertaken using a variety of techniques and selection of a “preferred” technique can be subjective. The Company has therefore sought to avoid any subjectivity by applying as many techniques as possible. Even though it is possible to argue that some techniques have greater relevance to the Company’s situation than others and should therefore have greater weight attached to them, nevertheless equal weight has been accorded to each result.

In summary, the benchmarking approaches have been:

- an aggregate unit cost to serve comparison across water companies using 2012/13 costs
- the same comparison using 2013/14 costs
- econometric modelling using 2012/13 costs
- econometric modelling using 2013/14 costs
- benchmarking across other industries, in particular energy retailers and mobile phone virtual network operators

For each technique, a high and low range of potential catch up efficiency factors have been provided. These are summarised below:
Catch up efficiency factors therefore range from 0.49% pa to 3.38% pa. A simple average of 1.57% of all the ranges has been adopted. As Economic Insight highlight, this is particularly aggressive in the context of the Company’s industry leading performance on bad debt costs, which is not taken into account in the econometric models (even though the cost of debt management is taken into account).

The combined effect of gross input price pressure, catch up efficiency savings, and economy-wide efficiency savings using the various benchmarking results is shown below:

<table>
<thead>
<tr>
<th>Benchmarking method</th>
<th>Implied pa % saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate unit cost (12/13)</td>
<td>1.13% - 1.36%</td>
</tr>
<tr>
<td>Aggregate unit cost (13/14)</td>
<td>0.49% - 0.58%</td>
</tr>
<tr>
<td>Econometric modelling (12/13)</td>
<td>1.31% - 1.57%</td>
</tr>
<tr>
<td>Econometric modelling (13/14)</td>
<td>2.82% - 3.38%</td>
</tr>
<tr>
<td>Wider industry bench-marking</td>
<td>1.41% - 1.69%</td>
</tr>
</tbody>
</table>

Source: Economic Insight
A net input price pressure claim of 0.97% pa is equivalent to the £2.8m over the AMP6 period included in the revised table R3 at Appendix 4

3.3.3. Evidence of the Company’s Approach to Cost Management
The Company has a strong track record on cost management and mitigation of the effects of external pressures – including input price pressures – on all its operating costs. Generic evidence is available from:

- PR09 operating cost efficiency modelling, which placed the Company in Band A (Lower)
- Operating cost performance against the PR09 allowances, as evidenced in the operating cost outperformance information accepted as part of the “legacy adjustments” in the Draft Determination, which showed outperformance of regulatory expectations of 8.52% over the first four years of AMP5.

This level of performance is not achieved without substantial management focus on management of all costs, including those in the Retail function. The Economic Insight report summarises evidence from Board level engagement through to the management of individual expense types within the Retail function, including:

- Board engagement in setting medium term efficiency targets (subsequently translated into operational budgets) as part of an annual Board strategic review;
- Monthly reporting to the Board on performance against cost targets (budgets) at departmental and expense type level;
- Alignment of management reward with achievement of cost as well as service performance targets;
- Weekly monitoring of performance against a range of departmental KPIs, including short-term variable costs such as overtime as well as service performance indicators;
- Management of employee costs through a combination of Company-wide processes (multi-year pay awards linked to PR09 efficiency targets, revisions to defined benefit pension arrangements, tight control of recruitment, promotions and progression awards) and departmental specific techniques (maintaining low staff turnover to minimise recruitment and training costs, benchmarking all new starting salaries against the local market);
- Management of the costs of debt by a combination of effective in-house resource (the Company employs its own field-based Customer Liaison Officers), use of best practice recovery intelligence and profiling (ACORN and EXPERIAN data sources), and innovative contracts with third parties (local solicitors incentivised through a reward mechanism linked to recovery rates) – generating an industry-leading performance on the minimisation of bad debt;
- Effective management of meter reading activities through an in-house meter reading team that consistently outperforms external benchmarks in terms of productivity (based on detailed local knowledge and the use of innovative, low-cost mobile technology);
- Management of other third party costs to achieve maximum efficiency (including dispatch of bills and reminders in batches optimising the trade-off between regularity of communications and discount for bulk dispatch, and competitive tendering of the bill production and dispatch contract).

Whilst the Company continually strives for further efficiencies – and indeed accepts a substantial efficiency challenge implicit in the reduced input cost pressures claim – there is
substantial and compelling evidence that current management practices mean that there is not the scope for mitigating all input cost pressures. The reduced input cost pressure claim evidenced in these representations should therefore be allowed in full in the Final Determination.

3.4. Additional Information on Cost Allocations

3.4.1. Introduction

The Draft Determination included a number of requests for additional information on the basis of cost allocations between Wholesale and Retail activities, and between household and non-household activities within Retail, and for an assessment of the impact of potential re-statements. Whilst most of the areas where additional information was requested – and is provided below- do not meet the materiality threshold for requiring an adjustment to Tables R3 and R4, the Company has nevertheless incorporated the restatements in the revised Table R3 at Appendix 4 as the table was being resubmitted to capture the effect of the reallocation between metered and unmetered costs and a revised assessment of input price pressures.

The following sections follow the order of information requested on page 22 of the Draft Determination for the Company.

3.4.2. Doubtful Debts

Ofwat requirement

Cross-check the allocation of doubtful debts based on write-offs against an allocation based on the movement in outstanding debt and show how different the allocation between household and non-household would be based on the movement in outstanding debt from 31 March 2013 to 31 March 2014).

Response

If the allocation of the movement in provision element of doubtful debts had been allocated based on the movement in outstanding debt, the allocation to non-household would increase by £40k, as shown below. (NB: Trade debtor figures are taken from the 2014 Annual Report, page 101.)

<table>
<thead>
<tr>
<th></th>
<th>31/03/2014</th>
<th>31/03/2013</th>
<th>Movement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measured household</td>
<td>5,835</td>
<td>4,840</td>
<td>995</td>
</tr>
<tr>
<td>Unmeasured household</td>
<td>725</td>
<td>638</td>
<td>87</td>
</tr>
<tr>
<td>Measured non-household</td>
<td>1,313</td>
<td>986</td>
<td>327</td>
</tr>
<tr>
<td>Unmeasured non-household</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>7,876</td>
<td>6,466</td>
<td>1,410</td>
</tr>
</tbody>
</table>
Recalculation of HH NHH allocation of doubtful debts

<table>
<thead>
<tr>
<th>Doubtful debts as at 31/03/14</th>
<th>Recalculated</th>
<th>Original</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>per above</td>
<td>allocation</td>
<td></td>
</tr>
<tr>
<td>Less actual write-offs</td>
<td>-294</td>
<td>-294</td>
<td></td>
</tr>
<tr>
<td>Movement in bad debt provision</td>
<td>304</td>
<td>304</td>
<td></td>
</tr>
<tr>
<td>Household</td>
<td>233</td>
<td>273</td>
<td>-40</td>
</tr>
<tr>
<td>Non-Household</td>
<td>71</td>
<td>31</td>
<td>40</td>
</tr>
</tbody>
</table>

However, the Company still considers than an allocation of the movement in the bad debt provision based on actual write offs is more reliable than one based on the movement in total debt outstanding, as the total debt outstanding will be heavily influenced by the timing of bills (particularly metered bills) being issued. Provisioning is based on the age and collection status of debt (reflecting the difficulty of collecting residual amounts outstanding), and no provision is made against amounts only just billed. The use of total amounts outstanding is therefore likely to generate an unreliable allocation.

3.4.3. Depreciation of General and Support Assets

Ofwat requirement

Revised tables R3 and R4 with capital costs and depreciation allocated in accordance with principal use guidance, including the allocation of general and support asset depreciation between Retail and Wholesale.

Response

All assets used by only one business unit are allocated directly to that business unit. All assets used by more than one business unit are allocated to General and Support. Principal use guidance, therefore, only affects General and Support assets, which comprise a number of asset classes with differing asset lives. Total depreciation of £694k on General and Support assets, which was previously all allocated to Wholesale, has now been allocated as follows:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Life</th>
<th>Driver</th>
<th>£ Wholesale</th>
<th>£ Retail</th>
<th>£ Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant</td>
<td>5 to 25</td>
<td>Area</td>
<td>62,733</td>
<td>18,078</td>
<td>80,810</td>
</tr>
<tr>
<td>Buildings</td>
<td>80 to 100</td>
<td>Area</td>
<td>220,713</td>
<td>63,604</td>
<td>284,317</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>3</td>
<td>Number of computers</td>
<td>18,871</td>
<td>7,878</td>
<td>26,749</td>
</tr>
<tr>
<td>PC's and Software</td>
<td>3</td>
<td>Number of computers</td>
<td>188,607</td>
<td>78,733</td>
<td>267,340</td>
</tr>
<tr>
<td>Cars</td>
<td>5</td>
<td>Direct costs</td>
<td>26,205</td>
<td>8,316</td>
<td>34,522</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>517,129</strong></td>
<td><strong>176,609</strong></td>
<td><strong>693,738</strong></td>
</tr>
</tbody>
</table>

Depreciation on buildings and plant has been allocated by the floor area of our head office building occupied by exclusively Wholesale and Retail employees. Depreciation on computers and office equipment has been allocated by the number of computers. General and support cars are those for Executive Directors, and so depreciation on these has been allocated by direct costs, which is the same driver as used for all other employment costs for these employees.
3.4.4. Rates, IT, Facilities and Grounds Maintenance

**Ofwat requirement**
Calculation demonstrating what the allocation of local authority rates, IT, and facilities and grounds maintenance costs between Retail and Wholesale would be if Ofwat guidance on cost drivers were to be adopted. In the event that the difference from the current business plan allocation was in excess of the materiality threshold for allocations between Retail and Wholesale (greater than 2% of R3 line1 plus R4 line 1), update these allocations in revised R3 and R4 tables.

**Response**
Details of the requested reallocations are shown below:

<table>
<thead>
<tr>
<th>2013/14 (in 2013/14 prices)</th>
<th>Wholesale</th>
<th>Retail</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rates Allocation as submitted (£s)</td>
<td>95,771</td>
<td>37,875</td>
<td>133,646</td>
</tr>
<tr>
<td>Driver Percentage of seats occupied in Head Office building</td>
<td>71.66%</td>
<td>28.34%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Revised Allocation</td>
<td>103,749</td>
<td>29,897</td>
<td>133,646</td>
</tr>
<tr>
<td>Driver Floor area of Head Office building (square metres)</td>
<td>2,207</td>
<td>636</td>
<td>2,843</td>
</tr>
<tr>
<td>Effect of reallocation</td>
<td>7,978</td>
<td>-7,978</td>
<td>0</td>
</tr>
<tr>
<td>Facilities Allocation as submitted (£s)</td>
<td>269,908</td>
<td>106,742</td>
<td>376,650</td>
</tr>
<tr>
<td>Driver Percentage of seats occupied in Head Office building</td>
<td>71.66%</td>
<td>28.34%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Revised Allocation</td>
<td>292,391</td>
<td>84,259</td>
<td>376,650</td>
</tr>
<tr>
<td>Driver Floor area of Head Office building (square metres)</td>
<td>2,207</td>
<td>636</td>
<td>2,843</td>
</tr>
<tr>
<td>Effect of reallocation</td>
<td>22,483</td>
<td>-22,483</td>
<td>0</td>
</tr>
<tr>
<td>IT Costs Allocation as submitted</td>
<td>279,021</td>
<td>116,476</td>
<td>395,498</td>
</tr>
<tr>
<td>Driver Percentage of seats occupied in Head Office building</td>
<td>71.66%</td>
<td>28.34%</td>
<td>100.00%</td>
</tr>
<tr>
<td>28.34% of the seats in the building</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IT Costs Revised Allocation</td>
<td>314,858</td>
<td>80,639</td>
<td>395,498</td>
</tr>
<tr>
<td>Driver Number of computers - see calculation</td>
<td>406</td>
<td>104</td>
<td>510</td>
</tr>
<tr>
<td>Effect of reallocation</td>
<td>35,837</td>
<td>-35,837</td>
<td>0</td>
</tr>
</tbody>
</table>
2% of the total of R3 line 1 plus R4 line 1 is £113.5k. The net effect of revised allocations undertaken in line with Ofwat guidance is £66.3k and is, therefore, below the materiality threshold.

Local authority rates, facilities and IT costs were previously allocated on the number of seats occupied within our Head Office building, to which the costs relate. Some seats are not occupied for the full day, e.g. Inspectors, who attend the office in the morning for one hour, and then go out on business for the rest of the day, thereby driving lower costs (for example, for heating and lighting) than employees who are in the building for the whole business day. Adjustments were previously made to account for these occurrences. Costs were therefore divided by an equivalent of the number of seats occupied for a full day, and then allocated to Wholesale and Retail on the same basis. The Company considers this approach a more accurate representation of cost drivers, because a person occupying a seat in the building for only part of the working day will consume less of the facilities than a person occupying a seat in the building for the whole day.

3.4.5. Ofwat requirement
A calculation demonstrating what the allocation of facilities and grounds maintenance between household and non-household would be in line with Ofwat guidance. In the event that the difference to the current Business Plan allocations is in excess of the materiality threshold for allocations between household and non-household (greater than 2% of R4 line 1), update the allocations in the revised R3 and R4 tables.

Response
The table below shows the original allocation to Retail split between household and non-household using number of customers, and the revised allocation to Retail (as shown in section c above) also split using number of customers. It is this second allocation that has been included in the adjustments built into the revised Table R3 at Appendix 4.

<table>
<thead>
<tr>
<th>Facilities</th>
<th>As submitted</th>
<th>Household</th>
<th>Non-HH</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Driver</td>
<td>% of directly allocated</td>
<td>99,227</td>
<td>7,515</td>
<td>106,742</td>
</tr>
<tr>
<td>Driver</td>
<td>costs</td>
<td>92.96%</td>
<td>7.04%</td>
<td>100.00%</td>
</tr>
<tr>
<td>As submitted (but using revised driver)</td>
<td></td>
<td>93,417</td>
<td>13,325</td>
<td>106,742</td>
</tr>
<tr>
<td>Driver</td>
<td>Number of customers</td>
<td>267,157</td>
<td>16,615</td>
<td>283,772</td>
</tr>
<tr>
<td>Revised Allocation to Retail</td>
<td></td>
<td>77,224</td>
<td>7,036</td>
<td>84,259</td>
</tr>
<tr>
<td>Driver</td>
<td>Number of customers</td>
<td>267,157</td>
<td>16,615</td>
<td>283,772</td>
</tr>
<tr>
<td>Effect of reallocation</td>
<td></td>
<td>-22,003</td>
<td>-480</td>
<td>-22,483</td>
</tr>
</tbody>
</table>

2% of R4 line 1 is £11k. The effect of this reallocation is £22k, and therefore passes the materiality threshold.
4. **Non-household retail**

4.1. **Introduction**

Ofwat’s Draft Determination for Non Household Retail is significantly different in form and content to the other Draft Determinations issued on 29 August, reflecting the difference in approach to future price controls for what will by April 2017 be a competitive market. In particular, the review of costs, margins and tariff structures is in Ofwat’s own words, “Light touch” and raised only one query with the Company’s Non-Household Retail proposals. This is addressed in section 3 below.

However, the Non-Household Draft Determinations asked companies to address a number of generic issues, which had been notified earlier in August under Information Note 14/14. The Company’s responses to these generic issues are set out below.

4.2. **Form and Duration of Non Household Retail Control**

Ofwat have invited companies to consider whether they would prefer to have

- A binding non-household price control set for five years, as proposed under the final PR14 methodology statement; or
- A change to the form of the control in some way that would allow them greater time to consider and address any issues, for example through a shorter control period (one or two years) or through a form of reopener for a five year control.

We have reviewed these options with our Customer Challenge Group on 18 September and, even though Ofwat have raised no material issues with the Default Tariffs included in our 27 June Business Plan Resubmission, we can see no disadvantage in accepting an opportunity to review Default Tariffs in the light of Final Determinations and developments over the next two years prior to market opening in April 2017.

We therefore propose that controls for Default Tariffs for are set for an initial control period of two years to March 2017 as a maximum. If significant issues emerge in the next 12 months, the facility should exist for controls to be re-opened for 2016/17 to enable such issues to be addressed prior to market opening (bearing in mind that the intention is for a “shadow market” to operate from October 2016).

4.3. **Engagement with Non Household Customers**

Draft Determinations and Information Note 14/14 also asked for evidence that companies had engaged with their customer challenge groups as a minimum, and “better still with local non-household customer groups as well”. In particular, companies should show that there is customer support for

- Any proposals to change the form or duration of the non-household retail control (as discussed above);
- The proposed structure of default tariffs and the associated average revenue controls; and
- The overall revenue levels included within controls.

As noted above, we reviewed our proposed response to the opportunity to change the duration of the non-household retail control with our Customer Challenge Group on 18
September. We reported that our 27 June Business Plan Resubmission was compliant with the allowed retail margin of 2.5% pa and circulated the default tariffs applicable for different customer types and in different charging areas, emphasising that the default tariffs had been developed specifically to mirror current integrated tariffs and minimise unforeseen incidence effects. We also highlighted the proposed margins by customer type. We also confirmed that the overall plan was presented to non-household customers as part of the Company’s engagement in 2013. We also noted our ongoing engagement with local businesses included a forthcoming presentation to the Gatwick Diamond business group in October 2014. The CCG was broadly supportive of the approach we have adopted and will comment in their report which is being submitted in parallel with the Company’s representations.

Customer support for the structure of our proposed revenue controls and default tariffs

Our acceptability testing has provided strong support for our business plan. In our customer research in October 2013 we received an 84% level of acceptability based on average bills that would increase by £7 above inflation over the five year period. This was based on research of 600 households and 200 non-household customers. The level of acceptability did not vary between the two customer types.

In May 2014 we carried out further customer research on the acceptability of our plan on 500 household customers with an inflation only increase. This received a 91% level of acceptability and we believe there is sufficient evidence to suggest that this strong level of support would also have been evident in our business customers.

Our ongoing engagement with our larger volume business customers provides us with strong evidence that our tariffs are acceptable. Dialogue with larger volume users tends to be specific to their situation and particular business needs and is conducted through our dedicated Key Account Manager. This ensures a good understanding of the tariff options available to their particular circumstances and the additional services that the Company can provide to add value to their activities, either by reducing overall costs, contributing to reductions in their environmental impact, or providing services that are not currently accessed. Evidence of informed tariff choices comes from the take-up rates for discounted tariffs, where approximately 70% of those eligible have switched to the discounted tariffs available. The 30% that have not switched have either made an informed decision based on an understanding of their projected usage pattern on potential future bills, or have concluded that the tariff they currently enjoy satisfies their expectations and switching is not something they give priority at present.

Ofwat confirmed at our clarification meeting on 18 September that the requirement for evidence that non-household customers found proposed revenue levels acceptable was difficult to achieve in any meaningful way and that support for tariff structures was the key requirement.

4.4. Non Household Retail Costs

The Draft Determination notes that the Company’s non-household operating costs in 2013-14 were significantly higher than the preceding two years and asked, as part of representations, for a clear explanation for the cost increase and an explanation of why the increase should not be treated as an exceptional one-off event.
The table below shows that non-household retail costs were significantly higher than in the preceding two years due to higher water efficiency and doubtful debt costs.

<table>
<thead>
<tr>
<th></th>
<th>27 June Resubmission</th>
<th>11/12</th>
<th>12/13</th>
<th>13/14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water efficiency</td>
<td></td>
<td>18</td>
<td>15</td>
<td>48</td>
</tr>
<tr>
<td>Doubtful debts</td>
<td></td>
<td>65</td>
<td>44</td>
<td>95</td>
</tr>
<tr>
<td>Other non-household costs</td>
<td></td>
<td>414</td>
<td>411</td>
<td>415</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>497</strong></td>
<td><strong>470</strong></td>
<td><strong>558</strong></td>
</tr>
</tbody>
</table>

The Company’s water efficiency initiatives were more focused on non-household activities in 2013/14 than they had been in the previous two years. This is a feasible outcome of our water efficiency work programme which targets activity in all customer groups. We use a cost effectiveness test to prioritise each individual project or initiative, and hence the year on year profile of this work will vary across the period as can be seen in the figures above for non-households. The successful application of this approach has resulted in our PR09 water efficiency target being delivered in the first 3.5 years of the current period.

Non-household projects of particular note in 2013/14 include:

- The expansion of our ‘Learn to save’ programme for schools to receive self-funding water efficiency advice and investment
- An increase in properties receiving water efficiency audits including an initiative targeted at the pubs and restaurants sector
- The use of our contractor who assists the company with underbilled properties to look for ‘over billed’ properties ie those whose use is more than expected and who we then approach to proactively promote an audit of their premises and site

The movement in the provision for doubtful debt was significantly higher in 2013/14 than it had been in the previous two years. The movement in provision in our submission was based on actual write-offs and then on accounts in debt, resulting in a movement in provision of £95k, as shown in the table below. A recalculation of the movement in the provision for doubtful debt was requested in the Draft Determination, based on the movement in actual debt. This results in a reallocation to non-household of a further £39k, which forms the bulk of the reallocations shown in the table below.

Neither of these cost movements is sufficiently unusual to be classified as exceptional one-off event, but whether it is or not makes no difference to the proposed Default Tariffs for AMP6 which are based on the forecast costs for the future years, which are actually close to the 2012/13 level anyway and do not include provisions for further bad debt increases or the additional level of non-household water efficiency work seen in 2013/14.
5. Appointee

5.1. Bill Profiles and PAYG Ratios

The Company’s 27 June Business Plan Resubmission proposed to hold prices to customers constant in real terms throughout AMP6, but the output from the Company’s financial modelling generated a profile of an increase in Wholesale charges in 2015-16 followed by four years of real price reductions. The Company proposed to make use of flexibility it understood would be available under the Wholesale price control to vary annual charges to maintain prices constant in real terms throughout AMP6.

The Draft Determination simply followed the bill profile included in the Company’s Plan, albeit at lower overall levels, but also provided clarification that there would not be the opportunity to vary annual Wholesale charges within AMP6 from the profile included in the Final Determination.

The Company therefore proposes that PAYG ratios be varied year on year to achieve bills of the same real level throughout AMP6, with a one-off real price reduction in 2015/16, as shown in Table 1 and Figure 1, repeated for convenience below.

<table>
<thead>
<tr>
<th>Table 1: Average bill (£s – before inflation)</th>
<th>2014/15</th>
<th>2015/16</th>
<th>2016/17</th>
<th>2017/18</th>
<th>2018/19</th>
<th>2019/20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Plan</td>
<td>179</td>
<td>187</td>
<td>181</td>
<td>179</td>
<td>176</td>
<td>171</td>
</tr>
<tr>
<td>Ofwat DD</td>
<td>176</td>
<td>180</td>
<td>173</td>
<td>169</td>
<td>165</td>
<td>160</td>
</tr>
<tr>
<td>Company Representation</td>
<td>178(^1)</td>
<td>176</td>
<td>176</td>
<td>176</td>
<td>176</td>
<td>176</td>
</tr>
</tbody>
</table>

\(^1\) Differs from Company Plan due to minor rounding differences

![Figure 1](#)

This requires PAYG ratios to be amended as shown below.
The principle of amending the PAYG ratio in individual years to avoid a one-off bill increase in 2015/16 followed by real reductions in subsequent years has been discussed with the Customer Challenge Group and the principle broadly supported. As the average PAYG rate over AMP6 has not been increased as a means of addressing financeability concerns, and bill increases have not been brought forward (rather, they have been avoided) no further customer research has been considered necessary.

5.2. Financeability

5.2.1. The Issue

The Company’s 27th June Business Plan Resubmission included Board assurance that the Company was financeable under the Plan – and that actual financial ratios were consistent with the BBB+/Baa1 target credit rating and complied with the financial covenants applicable under the Company’s £100m Index Linked Bond. By implication the Company was therefore deemed to be financeable under the lower gearing levels assumed under Ofwat’s industry-wide notional Balance Sheet structure.

The Draft Determination focuses upon financial ratios for this notional Balance Sheet structure, and produces financial ratios (under Ofwat definitions) lower than those in the Company’s Plan. The Adjusted Cash Interest Cover Ratio (AICR) in particular is considered low, although in the round, and taking into account a comfortable FFO/Debt ratio, Ofwat considers that the Company is financeable. However, because of differences in the calculation of the ratios Ofwat uses to assess financeability under a notional structure revealed during the query process, Ofwat has asked for Board and third party assurance that the Company is financeable on a notional basis, and has suggested that the Company may wish to consider using the PAYG mechanism to bring forward revenue into AMP6 to address the low level of AICR in particular. However, before bringing forward revenue under this mechanism the Company would need to engage with customers on any proposed change and explain the benefits of improvements in financial ratios on a notional basis.

5.2.2. Company Response

The Company considers Ofwat’s repeated reference to “errors” in the calculation of certain financial ratios unnecessary and misleading, given the extensive dialogue that had taken place through the query process following submission of the Company’s updated Business Plan on 27 June. In fact the ratios attributed to the Company in Ofwat’s Draft Determination reflected only the changes made in response to encouragement to make equal and opposite changes to the PAYG and RCV run-off rates to improve one financial ratio. Subsequent exchanges to incorporate further clarifications of Ofwat requirements were ignored in the Draft Determination and it has subsequently been confirmed that Ofwat simply ran out of time to complete their query process. This dialogue took place entirely around financial ratios as defined by Ofwat under a notional capital structure and ignored the key ratios as calculated by the major credit rating agencies on an actual balance sheet structure. These
representations include substantive assurance that the Company is financeable from a third
party, who presented their own findings to the full Board. This assurance focuses upon the
definition of ratios as used by two of the major ratings agencies.

The Company has engaged NERA to review the financial ratios resulting from Ofwat’s Draft
Determination, compare them to the threshold ratios used by credit rating agencies for
informing rating assessments, discuss them with the rating agencies, and provide the Board
with an opinion on whether the Company would be financeable (on a notional and actual
basis) under the Draft Determination.

The Company has also considered the impact of its representations on its financeability,
der under both a notional and an actual Balance Sheet structure, and sought external assurance
from NERA on the resulting ratios and likely credit rating. Finally, the Company has
considered the impact of its position following representations on its compliance with the
financial covenants associated with its current financing structure.

Given the importance attached to the Board considering independent assurance on
financeability, NERA attended the Board meeting on 1 October when the Company’s draft
representations were reviewed. The Board considered and agreed with NERA’s fundamental
premise that financeability should be interpreted as the ability to maintain an investment
grade credit rating under the definition of financial ratios adopted by the rating agencies,
which differed between agencies, were often different from the definitions adopted by Ofwat
and were normally considered in the context of other rating considerations (including
business risk profile and regulatory environment). The Company maintains public ratings
from Moody’s and Standard and Poor’s (S&P), so use of these agencies’ methodologies for
assessing financeability in AMP6 provided an important link to the ratings and underlying
ratios already in existence. Having considered the assurance and assessment provided by
NERA, the Board confirmed that it considered the Company financeable on a notional and
actual capital structure under both the Draft Determination and after incorporation of the
Company’s representations. The Board went on to stress that its confirmation that the
Company was financeable on a notional basis under the Draft Determination could not be
construed as acceptance of the Draft Determination as a fair reflection of customers’ views
and priorities, and in no way contrary to the importance of the representations being made by
the Company.

NERA’s report, which includes annual ratios as well as the AMP6 averages quoted below, is
attached to these representations as Appendix 10.

Each of the scenarios considered by the Board is discussed below.

5.2.3. Financeability under the Draft Determination
Notional Structure
NERA have recalculated the financial ratios produced by Ofwat’s financial model for the Draft
Determination under a notional balance sheet structure and considered the rating which
might be applied by the Credit Rating Agencies if the Company were to have the lower level
of gearing assumed in the notional balance sheet structure. NERA has held a series of
discussions with Moody’s to understand their approach to a hypothetical notional rating for
the Company. Moody’s rating guidance for water companies focuses upon Gearing and the Adjusted Interest Cover Ratio (AICR). For companies with securitisation, they would also consider the distribution lock-up covenant levels. For covenants with the thresholds applicable in the Company’s case, AICR would typically be $1.5x$ – higher than the $1.3x$ generally applicable, partly due to minor differences in the definition of the ratio, but principally because Moody’s would like to see a higher AICR for smaller companies. The base rating would therefore be Baa2, with a one notch upgrade to Baa1 due to the distribution lock up covenants associated with the Company’s Bond. The resulting Baa1 rating (consistent with the Company’s current rating) would however be under some downward pressure due to the low level of the AICR ($1.34x$, compared with $2.3x$ at the last rating in September 2013). The key metrics are summarised below.

NERA have also discussed the Company’s potential rating under a notional capital structure with S&P, who currently have the Company rated BBB with a Positive Outlook. S&P’s methodology consider the business risk profile and the financial risk profile of a company to determine an “anchor” point for the rating. FFO/Debt is the key financial ratio, supplemented by other ratios where the FFO/Debt ratio is at the “aggressive” end of expectations. Liquidity, governance and management, or comparable ratings factors may be used to amend the “anchor” rating. The Company is currently rated as “Excellent” in terms of business risk with a “significant” financial risk rating. With the FFO/Debt ratio implicit in the Draft Determination, the “anchor” rating would be A-, which would come back to BBB if the modifiers for governance and comparable ratings used in the last published rating in May 2014 were to continue to be applied. The key metrics for S&P are also summarised below:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Forecast for Notional Company - PR14 Average</th>
<th>Rating at Covenant Levels</th>
<th>Moody’s General Grid Methodology</th>
<th>Moody’s Guidance for Regulated UK Water</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gearing</td>
<td>64.5%</td>
<td>80.0%</td>
<td>Baa</td>
<td>Baa2</td>
</tr>
<tr>
<td>Adjusted Cash Interest Cover</td>
<td>$1.34x$</td>
<td>$1.5x*$</td>
<td>Ba</td>
<td>Baa2**</td>
</tr>
<tr>
<td>FFO / Net Debt</td>
<td>13.8%</td>
<td>13.8%</td>
<td>Baa</td>
<td>n/a</td>
</tr>
<tr>
<td>RCF / Capex</td>
<td>0.9x</td>
<td>0.9x</td>
<td>Ba</td>
<td>n/a</td>
</tr>
<tr>
<td>Indicated Rating</td>
<td></td>
<td></td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td>Uplift for Creditor Protection</td>
<td></td>
<td>+1</td>
<td></td>
<td>+1</td>
</tr>
<tr>
<td>Total Score</td>
<td></td>
<td></td>
<td>Baa1</td>
<td>Baa1</td>
</tr>
</tbody>
</table>

NERA have also discussed the Company’s potential rating under a notional capital structure with S&P, who currently have the Company rated BBB with a Positive Outlook. S&P’s methodology consider the business risk profile and the financial risk profile of a company to determine an “anchor” point for the rating. FFO/Debt is the key financial ratio, supplemented by other ratios where the FFO/Debt ratio is at the “aggressive” end of expectations. Liquidity, governance and management, or comparable ratings factors may be used to amend the “anchor” rating. The Company is currently rated as “Excellent” in terms of business risk with a “significant” financial risk rating. With the FFO/Debt ratio implicit in the Draft Determination, the “anchor” rating would be A-, which would come back to BBB if the modifiers for governance and comparable ratings used in the last published rating in May 2014 were to continue to be applied. The key metrics for S&P are also summarised below:
Under both rating agencies approaches, therefore, NERA conclude that the Company will be able to retain its investment grade credit rating under a notional structure, albeit with some downward pressure on current ratings. The allowance of the proposed company-specific uplift to the allowed cost of capital would alleviate the downward pressure, particularly from the higher rating from Moody’s.

**Actual Structure**
The ratings rationale under the higher level of gearing implicit in the Company’s actual balance sheet structure does not change for either Moody’s or S&P. The Moody’s rating remains securely in the current rating of Baa1, as shown below, largely because the rating is assessed at covenanted rather than forecast levels.

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Forecast for Actual Company - PR14 Average</th>
<th>Rating at Covenant Levels</th>
<th>Moody’s General Grid Methodology</th>
<th>Moody’s Guidance for Regulated UK Water</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gearing</td>
<td>73.3%</td>
<td>80.0%</td>
<td>Ba</td>
<td>Baa2</td>
</tr>
<tr>
<td>Adjusted Cash Interest Cover</td>
<td>2.00</td>
<td>1.5x</td>
<td>Ba</td>
<td>Baa1</td>
</tr>
<tr>
<td>FFO / Net Debt</td>
<td>14.0%</td>
<td>14.0%</td>
<td>Baa</td>
<td>n/a</td>
</tr>
<tr>
<td>RCF / Capex</td>
<td>1.36</td>
<td>1.36x</td>
<td>Baa</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Indicated Rating</strong></td>
<td><strong>Baa2</strong></td>
<td></td>
<td></td>
<td><strong>Baa2</strong></td>
</tr>
<tr>
<td><strong>Uplift for Creditor Protection</strong></td>
<td><strong>+1</strong></td>
<td></td>
<td></td>
<td><strong>+1</strong></td>
</tr>
<tr>
<td><strong>Total Score</strong></td>
<td>Baa1</td>
<td></td>
<td></td>
<td>Baa1</td>
</tr>
</tbody>
</table>
For S&P, the key FFO/Debt ratio over AMP6 declines to an average of 9.1%, but is expected to be sufficient to retain the A- anchor rating. Together with the current modifiers for governance and comparable ratings, NERA conclude that the Company "may" retain its current overall rating of BBB with a Positive Outlook. The key ratios for S&P under the Company's actual balance sheet structure are shown below.

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Forecast for Actual Company - PR14 Average</th>
<th>S&amp;P Financial Risk Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FFO / Debt</td>
<td>9.1%</td>
<td>Significant</td>
</tr>
<tr>
<td>Debt / EBITDA</td>
<td>6.4</td>
<td>Highly Leveraged</td>
</tr>
<tr>
<td>FFO / Cash Interest</td>
<td>4.8</td>
<td>Intermediate</td>
</tr>
<tr>
<td>EBITDA / Interest</td>
<td>2.6</td>
<td>Significant</td>
</tr>
<tr>
<td>CFO / Debt</td>
<td>10.5%</td>
<td>Significant</td>
</tr>
<tr>
<td>FOCF / Debt</td>
<td>1.1%</td>
<td>Significant</td>
</tr>
<tr>
<td>DCF / Debt</td>
<td>-0.3%</td>
<td>Aggressive / Significant</td>
</tr>
</tbody>
</table>

### 5.2.4. Financeability after the Company’s Representations

The Company’s representations propose using the flexibility available through annual modifications to the PAYG ratio to achieve a flat bill profile through AMP6. Financial ratios and overall financeability have therefore been tested and assured on both a notional and actual financial structure against this proposed revenue profile.

**Notional Structure**

NERA's conclusion on the Company's representations is that they improve financial ratios under a notional balance sheet structure, but the overall rating would remain at Baa1 under Moody’s approach. The underlying AICR improves to 1.59x, but still remains lower than the 2.3x calculated by Moody's in their last published credit opinion for the Company. Baa1 status is achieved with the one-notch uplift for the securitisation features of the Company's Index Linked Bond. The key ratios are show below.
NERA also conclude that the Company would stay rated at BBB by S&P. FFO/Debt improves to 10.5% on average over AMP6 (similar to the 10-11% S&P estimate for 2013/14, but the anchor rating still remains at A-, with a rating after modifiers of BBB. The key ratios are shown below.

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gearing</td>
<td>68.2%</td>
<td>80.0%</td>
<td>Ba</td>
<td>Baa2</td>
</tr>
<tr>
<td>Adjusted Cash Interest Cover</td>
<td>1.59</td>
<td>1.5x</td>
<td>Ba</td>
<td>Baa1</td>
</tr>
<tr>
<td>FFO / Net Debt</td>
<td>13.4%</td>
<td>13.4%</td>
<td>Baa</td>
<td>n/a</td>
</tr>
<tr>
<td>RCF / Capex</td>
<td>1.07</td>
<td>1.07x</td>
<td>Baa</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Indicated Rating</strong></td>
<td></td>
<td></td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td><strong>Uplift for Creditor Protection</strong></td>
<td></td>
<td></td>
<td>+1</td>
<td>+1</td>
</tr>
<tr>
<td><strong>Total Score</strong></td>
<td></td>
<td></td>
<td>Baa1</td>
<td>Baa1</td>
</tr>
</tbody>
</table>

**Actual Structure**

Finally, NERA observe that financial ratios for the actual capital structure after representations are very similar to the equivalent levels under the Draft Determination.

As Moody’s consider gearing and AICR at covenanted levels, little change would be expected, as show below.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FFO / Debt</td>
<td>10.5%</td>
<td>Significant</td>
</tr>
<tr>
<td>Debt / EBITDA</td>
<td>6.5</td>
<td>Highly Leveraged</td>
</tr>
<tr>
<td>FFO / Cash Interest</td>
<td>4.1</td>
<td>Intermediate</td>
</tr>
<tr>
<td>EBITDA / Interest</td>
<td>3.3</td>
<td>Significant</td>
</tr>
<tr>
<td>CFO / Debt</td>
<td>10.2%</td>
<td>Significant</td>
</tr>
<tr>
<td>FOCF / Debt</td>
<td>0.2%</td>
<td>Significant</td>
</tr>
<tr>
<td>DCF / Debt</td>
<td>-2.6%</td>
<td>Aggressive</td>
</tr>
</tbody>
</table>
Similarly, S&P’s rating would be unlikely to change, with an A- anchor rating and BBB with positive outlook after possible modifiers.

![Ratio Table]

The Company’s principal constraints under its actual balance sheet structure, however, are the financial covenants associated with its Index Linked Bond. The original Business Plan Submission in December 2013 and the 27 June Resubmission both explained that the constraints imposed by this actual financing structure had been met by severely curtailing ordinary dividend payments in the early years of AMP6.

The reduction in allowed revenue, particularly the reduction in the assumed company specific uplift to the allowed cost of capital, puts further constraints upon these ratios, such that no ordinary dividend from the appointed business is possible in the first two years of AMP6 and the pay out in year three is restricted to £1.6m. Only in the last two years of AMP6 is an ordinary dividend in line with the supposed allowed cost of equity payable.

5.3. Uncertainty and Gain Share Mechanism

5.3.1. The Issue
The Company’s Business Plan includes a proposed mechanism for sharing with customers the benefits of better than expected performance, under which any dividend payments in excess of 10% of regulatory equity will be matched by an equivalent amount set aside for...
customers. The mechanism is intended to operate on an annual basis and be “one-sided” in the sense that dividend payments lower than the allowed cost of equity will not be offset against higher dividends in other years. The Company will consult customers as part of the PR19 price setting process on how they wish to deploy any monies set-aside under the mechanism – either as a reduction in future bills, or additional investment in specific activities (for example, additional network resilience, or additional water efficiency measures).

The Draft Determination proposes no intervention on this mechanism, but suggests that it may not be consistent with incentive based regulation because it might reduce the incentive for the Company to seek efficiencies and outperform cost assumptions. The Determination also notes that the mechanism could duplicate outperformance shared through the totex menu and suggests that it is unclear how this would be taken in account given that the PR19 totex reconciliation will not take into account any gain sharing undertaken voluntarily by the Company. Finally, the Determination notes that the Company should consider how the arrangement will work alongside the proposed Wholesale Revenue Forecasting Incentive Mechanism, which may result in penalties for under or over recovery of revenue.

5.3.2. Company Proposal
The Company does not believe that the existence of this mechanism will reduce the incentive to outperform cost allowances in Final Determinations, as there is no automatic presumption that cost outperformance will trigger a higher level of dividend payment. Moreover, the Company sees no conflict between the mechanism it has proposed and those that the regulator is putting in place for the whole of the industry. Expected levels of performance over the whole of AMP6 and their impact on rewards and penalties in AMP7 under the incentives put in place by PR14 Final Determinations will need to be taken into account by the Board in determining whether a dividend should be paid in any particular year, and if so, what the quantum of any payment should be. This will require a regular update of expected performance under all regulatory incentives, similar to that which the Board has successfully operated in AMP5. A decision to pay a dividend of greater than 10% would clearly be taken with a full understanding that an amount equivalent to the excess over 10% would need to be ring-fenced for use as customers determine at the next price review. Such ring-fencing would be independent of any industry-wide mechanisms established at the current Price Review, which would be expected to operate as defined in Final Determinations.

The Company does not, therefore, see any duplication or confusion over how the mechanism will operate in practice provided that the terms of regulatory incentives are clear from Final Determinations. This was certainly not the case for all mechanisms established under PR09 Final Determinations. The Company therefore urges Ofwat to ensure that the detail of proposed regulatory incentives included in Final Determinations are sufficiently clear, and worked examples are published well before 1 April 2015.

5.4. Taxation
Ofwat’s financial model initially calculates tax allowances on the basis of a notional Balance Sheet and then attempts to convert the resulting allowance into one based on the company’s actual Balance Sheet (as required by the established methodology for funding forecast actual tax charges). This is a circuitous exercise and requires the input of adjustments calculated
outside the financial model. It is therefore difficult to verify the accuracy of the resulting allowance.

However a number of issues have been identified that should be addressed in Final Determinations

- The Company has preference shares and pays preference dividends. For accounting purposes these are treated as debt, and have been included in debt within Ofwat’s financial model. They are not, however, tax deductible and therefore need to be added back to taxable profits to determine the appropriate tax charge. This does not appear to have been done – and taxable profits are therefore understated by £966k pa (with a commensurate understatement of tax allowances)

- The Company pre-paid issuance costs for its £100m Index Linked Bond and is amortising the issuance costs over the life of the Bond at £442k pa. These costs should be included in interest costs as they are tax deductible.

- More generically, the interest rates used for determining taxable profits for the purpose of calculating tax allowances are based on the standard assumptions for financing costs included in the WACC and, to the extent that these differ from the actual financing costs a company faces, will over- or under-state allowances for tax built into allowed revenue. For example, the actual coupon on the Company’s £100m index linked bond is 2.874%, not the 2.75% standard assumption. Taxable profits and therefore tax allowances will as a result tend to be overstated.

5.5. Scenarios

Following publication of Draft Determinations, Ofwat subsequently asked for the Company to consider the risk analysis included in the 27 June Business Plan Resubmission, principally to reflect the impact of the changes to Outcome Delivery Incentives (ODIs) included in Draft Determinations. Where risks on totex performance had been based on historic variations in performance against allowances, changes in totex allowances in the Draft Determination would not be expected to change the percentage variation in risk. Robust evidence would be required for changes to other risks arising from changes in ODIs.

The risk analysis submitted as part of the query process following the Company’s 27 June Business Plan Resubmission reflected historic variations in expenditure against allowances in price limits and other factors, which were accepted in the Draft Determination. The Company consider that they remain valid. Tables A20 and A20a have therefore been updated purely for the impact of the revised ODIs, and are included as Appendix 6. The Risk Assessment Tool has also been updated to reflect this change and the allowed cost of capital (including the allowed cost of debt) included in the Draft Determination, and is being submitted in parallel with these representations.

5.6. Affordability

5.6.1. Introduction

On page 38 of our draft price control determination notice, Ofwat stated it would expect the Company to establish an ongoing communications programme, including engaging with
Thames Water, in order to inform customers of the effects of the Thames Tideway on their bills.

5.6.2. Our response
We have attended high level meetings with Thames Water to discuss the likely impacts on customers’ bills, the predicted level of increased customer contact and discuss the stakeholder engagement programme.

We are aware that Thames Water has a performance commitment which states “We will engage with our customers to build understanding of the Thames Tideway Tunnel project”.

The detailed definition of the performance measure says that “Thames Water will undertake a programme of ongoing engagement with our customers and collaborate with water-only companies to understand and measure customers' views”. This includes a commitment to develop a joined up communications strategy.

In more recent communications Thames Water has stated that its intention is to collaborate with all the water-only companies in the region and the new Infrastructure Provider to develop an integrated communications strategy. For example, we would work with Thames Water on an overall approach as well as specific key messages. There would be shared materials, such as dedicated webpages and printed materials we can share with customers.

Thames Water will use its own communications channels, and piggyback on our customer communication activities. As an example, we intend to set aside space in our customer magazine to communicate this topic. We will also include signposts to more comprehensive information on outgoing correspondence such as bills and emails.

Thames Water has stated that it wants to better understand what is shaping customers’ views and what their concerns are and measure how perceptions change. Thames Water has committed to sharing this research with us.

The overall aim will be to ensure that everything is joined up and the engagement campaign has maximum impact. We understand Thames Water plans to set up a working group of the interested parties including South East Water, Affinity Water and ourselves. We plan to hold more detailed discussions with Thames Water on the communication programme in October 2014.

5.7. Charges

5.7.1. Overview
Ofwat’s Draft Determination includes (at Technical Appendix 8) a description of the information requirements relating to the setting of charges, in particular for the year 2015/16. A spreadsheet template has been provided by Ofwat which has been completed by the Company and is incorporated within these representations at Appendix 8.

Whilst not strictly a part of the Company’s representations on matters that we consider need changing in the Draft Determination, the exercise has proved invaluable in identifying issues that need addressing before the final charges schedule for 2015/16 can be completed. The Company therefore regards the template included at Appendix 8 as work in progress and is
proposing to continue working on it, in conjunction with Ofwat, to resolve issues of principle and data inconsistencies.

5.7.2. Approach
In order to demonstrate compliance with the separate price controls in the Draft Determination we have divided our tariffs as appropriate between retail and wholesale components. The projected revenues have then been aggregated to generate total revenues applicable to each price control.

In processing these charges, we have had difficulty in balancing the revenues for the non-household price control for both retail and, in particularly, wholesale. As shown on the table below there are shortfalls in the Draft Determination data compared to that included in Table R4 of our June Resubmission that we have been unable to understand.

<table>
<thead>
<tr>
<th></th>
<th>SESW R4 Submission 27/06/14</th>
<th>Ofwat DD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail (£m)</td>
<td>0.770</td>
<td>0.739</td>
</tr>
<tr>
<td>Wholesale (£m)</td>
<td>11.429</td>
<td>10.243</td>
</tr>
</tbody>
</table>

Table: Non-household revenues

We have completed the spreadsheet template using our existing 2014/15 tariffs (broken down into Wholesale and Retail components), before the real increase in prices for 2015/16 included in the Draft Determination. As it stands, the schedule generates an over recovery of revenues in both retail and wholesale for the non-household price control (before the real price rise included in the Draft Determination. We intend to carry on working on the analysis over the coming weeks in preparation for the charges submission at the end of the year to better understand why this is the case. We would also seek further discussions with Ofwat as part of this work to confirm that our assumptions about the data are correct.

5.7.3. Key Assumptions
Other key assumptions adopted in our process to calculate the tariffs for each price control are summarised below:

- We have used mid-year forecast property numbers as the multipliers to generate year average totals to match forecast revenues;
- We have incorporated our Social Tariff charge and discount entirely within household retail revenues. We have shown that the charge and discounts generate a revenue neutral effect. However, we note that administration costs will also be funded from the money collected from non-eligible customers and hence the number of customers who are offered the tariff may not reach that included as the charge multiplier in the spreadsheet. Our performance commitment is based upon assisting 5,000 customers with this tariff
- Open Water costs have been allocated to charges for both measured and unmeasured non-household properties in wholesale. The unmeasured component is applied as a fixed charge. This is appropriate since all our unmeasured non household customers
are likely to be low users. The charge to all other customers is a variable charge matched to consumption.

- The bill profiles included in the relevant sheet are based on those typically viewed by the Company when it updates its charges. We note that this currently will not incorporate any incidence effects as we have not increased our charges for the reasons outlined above. However, we remain concerned about the likelihood that charges could increase above 5% for a number of customers once RPI and bill profiles have been taken into account. We would urge Ofwat to consider our proposal for bill flattening set out in Section X.X of this response, to reduce the likelihood of these incidence effects.

5.7.4. Other Observations

Other observations from this trial exercise worth noting are captured below.

- We note that in order to make the variances function as designed the units of the revenue totals on several of the sheets have been reduced by 1000.
- We have completed the wholesale charges table to apply to our Northern tariff zones only. Our Southern tariff zone has different wholesale costs. We have only included non-household costs.
- The company does not offer non-potable or interruptible tariffs.
- The company does not offer seasonal or block related charges. We have inserted the same tariff for each month as appropriate within the template.