

# DWMP Webinar: Water Company Funding

December 2021



from  
**Southern  
Water** 

The Southern Water logo graphic consists of three stylized, wavy blue lines of varying lengths, positioned to the right of the text.

# What I plan to cover in today's session

- Regulatory context
- How are water companies are funded
- 5 year Business Planning: what needs to be considered
- Price review 2024 (PR24)
- Ofwat's business plan assessment
- Your involvement in PR24



# Regulatory Context

# Why are water companies regulated?

## Shoes

- ✓ Many suppliers
- ✓ Many products
- ✓ Price variation
- Customers exercise choice
- Good suppliers succeed
- Poor suppliers fail



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## Water

- ✓ One supplier
- ✓ One product
- ✓ One price
- No customer choice
- No competitive pressure
- Economic regulation to **protect** customers



# Ofwat regulate us, they have clear duties...



## Primary duties

| Companies Function Correctly  | Companies Financeable   | Protect Customers & Promote Competition   | Ensure Service Delivery   |
|---|---|---|---|
| Secure that the functions of each undertaker (companies) are properly carried out | Secure that undertakers are able to finance their functions, in particular by securing a reasonable rate of return on their capital | Protect the interests of consumers, wherever appropriate by promoting effective competition | Secure that companies with water supply licences properly carry out their functions |

## Secondary duties

|  |   |  |   |   |   |
|--|---|--|---|---|---|
| Contribute to the achievement of sustainable development | Secure that no undue preference or discrimination is shown by companies in fixing charges | Secure that consumers' interests are protected where companies sell land | Have regard to the principles of best regulatory practice | Ensure that consumers' interests are protected in relation to any unregulated activities of companies | Promote economy and efficiency by companies in their work |
|--|---|--|---|---|---|



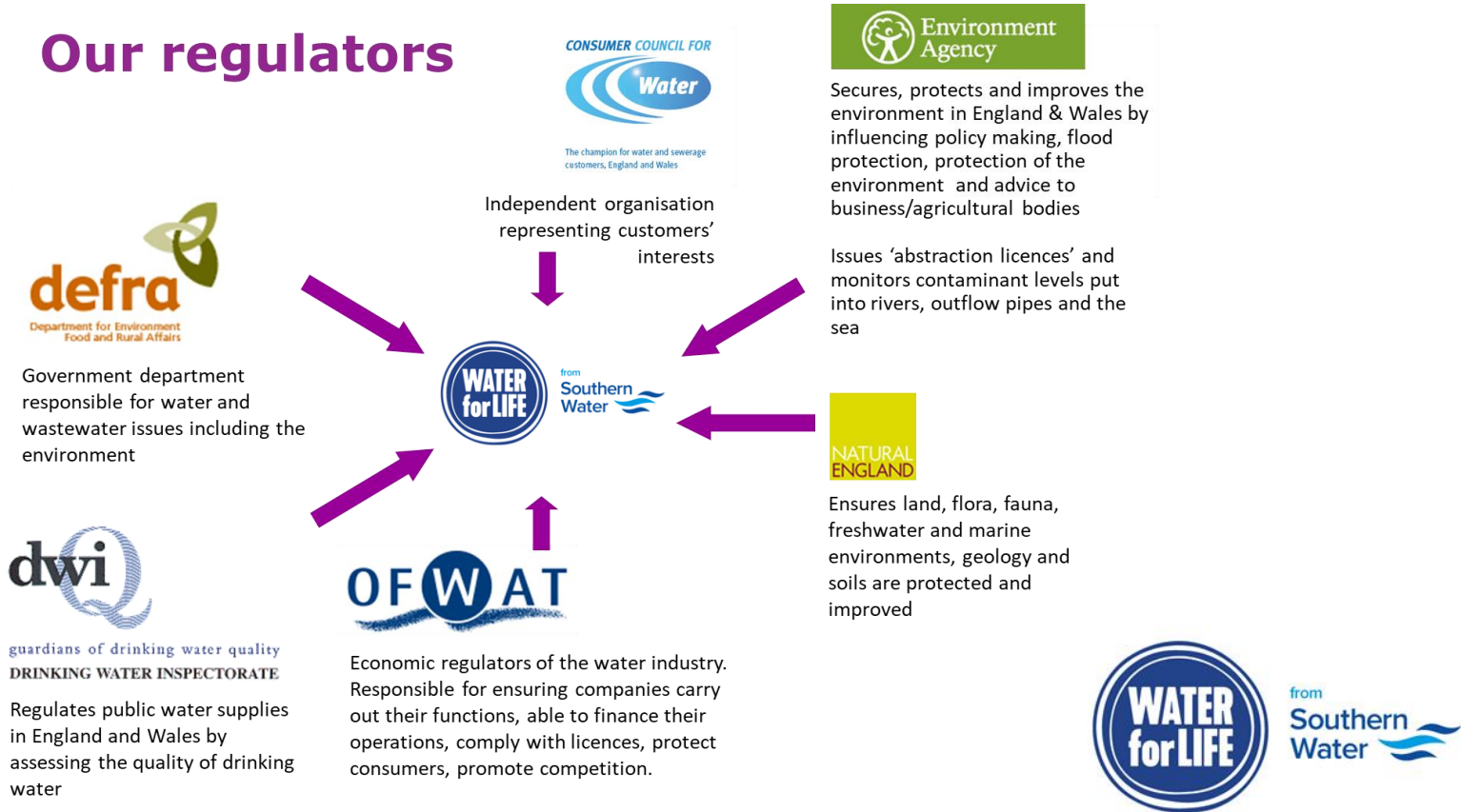
# Ofwat **does not** fund water companies – it regulates how much companies are allowed to charge customers for the service provided

- Price reviews every 5 years allow Ofwat to check water companies costs, performance & service to customers
- We must be able to prove to Ofwat in our business plan submission that our future plans are:
  - Affordable (including provision for the most vulnerable) and acceptable to customers
  - Financeable – Our investors should be able to make modest return
  - Meet the needs of customers & stakeholders
  - Delivers on performance and service to customers
  - Resilient to long term threats – E.g. Climate change, population growth, social change etc.
  - Delivers on regulatory commitments – E.g. WINEP, DWI, WRMP, DWMP etc.
  - Are deliverable, assured, customer/stakeholder supported, Board approved.



# Ofwat are just one of the many regulators we work with when developing our plans – some listed below

## Our regulators

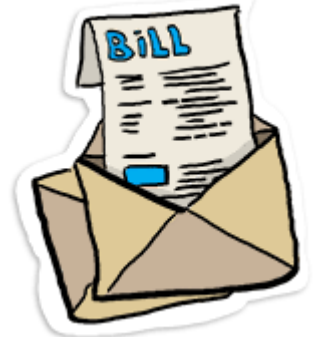




# How Are Water Companies Funded

# Funding to pay for **everything** water companies have to **deliver** comes from...

- **Customer bills**
- **Investors investment**
- **Smaller sources of income:**
  - Commercial activities that provide an income stream
  - 3<sup>rd</sup> party grants and contributions – E.g. bulk supply water exports
- Every 5 years, through the Price Review process, Ofwat checks that revenue levels in all of these areas are reasonable and that customers are paying a fair price for their service levels



# Investor areas for potential returns – Assessed by Ofwat



|   |   |
|---|---|
| Allowed Return on Capital Investment (WACC)   | <ul style="list-style-type: none"><li>• Set return on capital that Ofwat allows the companies to make</li></ul>   |
| Efficient Totex   | <ul style="list-style-type: none"><li>• Underspend allowed levels of investment through efficiency</li></ul>  |
| Performance (ODIs)  | <ul style="list-style-type: none"><li>• The better we perform the lower the penalties and greater the rewards; more potential for returns or re-investment</li><li>• No regulator fines (or clean-up costs) – any fines hit profits</li></ul> |
| Other Income (e.g. Commercial)  | <ul style="list-style-type: none"><li>• Other commercial entities can provide income that either gets re-invested or provides opportunity for returns (e.g. trade effluent, renting land / property etc.)</li></ul>                           |
| <b>Total Potential Return = Sum of all components above</b><br>Company Board must weigh up how much to re-invest or pay out to shareholders |   |

Underspend Shared with Customers (64% to Customers)

Penalties Returned to Customers via Bill Reductions and Fines Paid to HM Treasury



# **But...**future returns on investment are reliant on investors **doing the right thing** for customer and the environment

## Why Invest?

- Returns on investment tend to be lower compared to other investment opportunities
- Are less risky and steady – Water industry investors in it for the long term gains
- Ideal for less risky investments such as Pension funds

## Cash Injections

- Investors may choose to spend more than their Ofwat allowed levels – This might hit their short term profits, but this may be required to improve performance and/or improve future profitability position
- Investors may choose to invest in more commercial activities to gain greater returns later on too



# 5 Year Business Planning: What Needs To Be Considered

# Business plans are complex – Consideration given to lots of different aspects that deliver for customers and environment



Performance & Risk Appetite Levels



Positioning Against Our Peers



Our ESG Approach

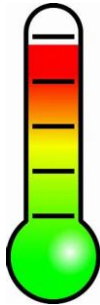


Our People Approach

Net Zero Carbon Approach



Our Procurement Approach



Size of Torex Plan

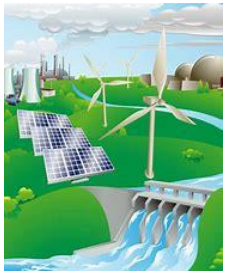


Must Build Customer & Regulator Trust



Nutrient Neutrality Approach

Planning & Delivery: Combination of Traditional & Nature Based Solutions



Commercial Approach & Markets

No. of Cost Claims



Reputation: Expectation Levels



Our Customer & Stakeholder Priorities



Our Brand Positioning



# Water is in the sights of politicians and stakeholders

**IS THIS THE END?**

**Labour targets water industry first for nationalisation**

**The shadow chancellor of the exchequer used his keynote speech at today's (24 September) Labour party conference to unveil the party's plans for a publicly-owned water system**

**Gove launches searing attack on water company bosses over tax avoidance and executive pay**  
The Environment secretary said the firms have 'avoided paying taxes' and 'rewarded the already well-off'

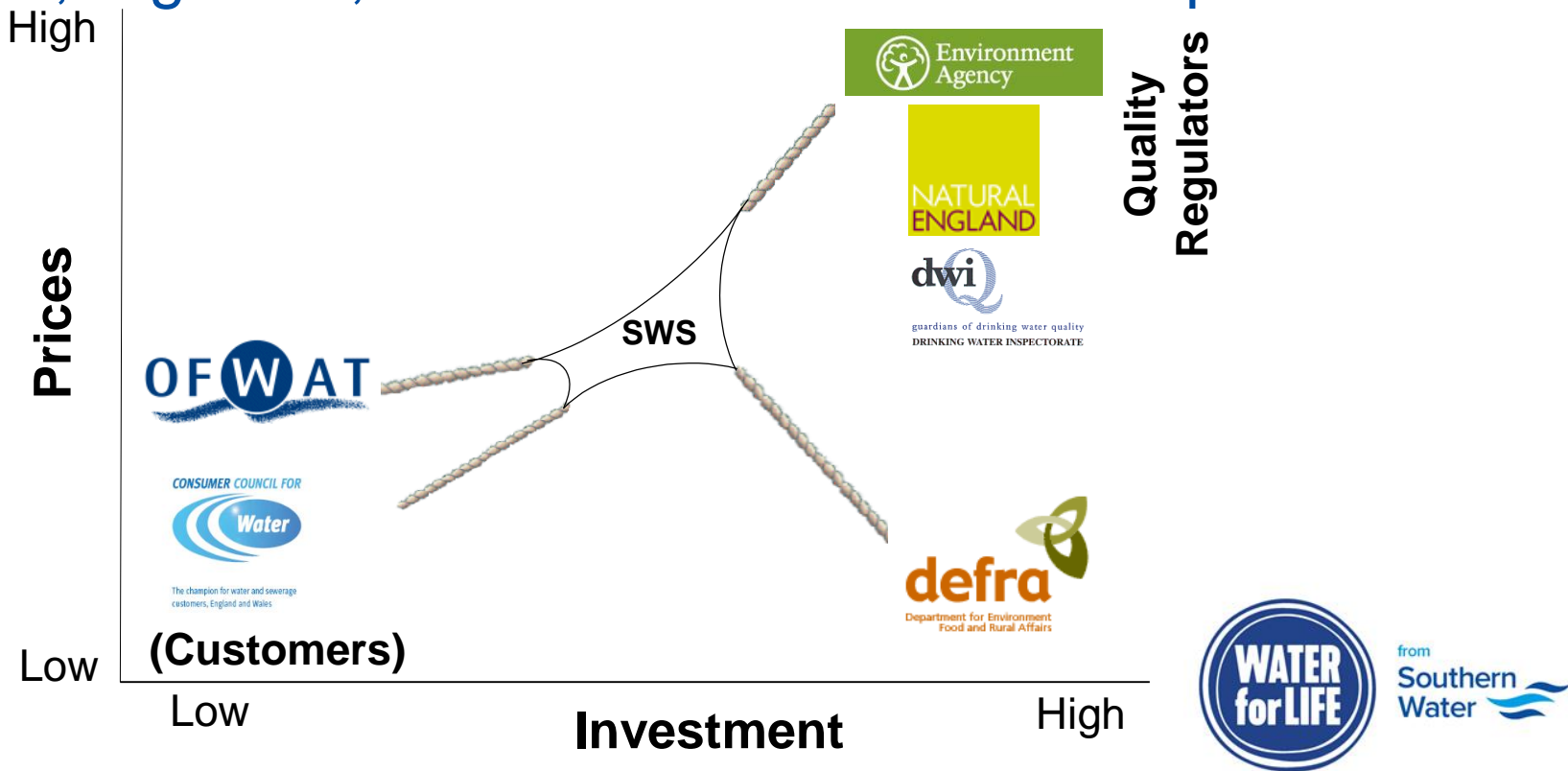
**We too consider that the corporate behaviour of some water companies has diminished trust in the delivery of this most vital service. Some companies are seen as focussed on financial engineering at the expense of public Service.**  
Ofwat April 2010

**Environment Agency tells water companies to clean up their act and protect the environment from pollution**

**FIERCE STORMS**



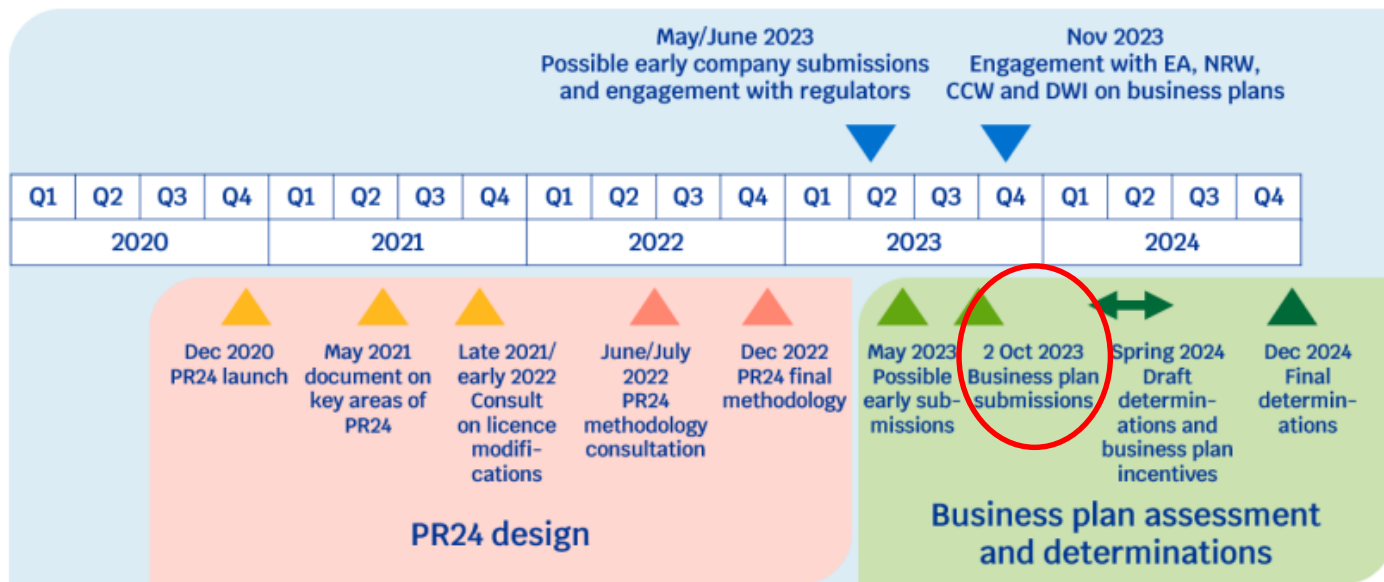
# The Challenge: Companies have to find a careful balance between investment levels & bill prices whilst trying to meet investor, regulator, customer & stakeholder requirements





# Ofwat's process is complex and data intensive

- Efficient costs...
- Upper quartile targets...
- Customer consultations...
- Investor returns..
- Incentives...
- Bill impacts



# Price Review 2024 (PR24)

# PR24 plans will need to demonstrate action and evidence against each Ofwat theme



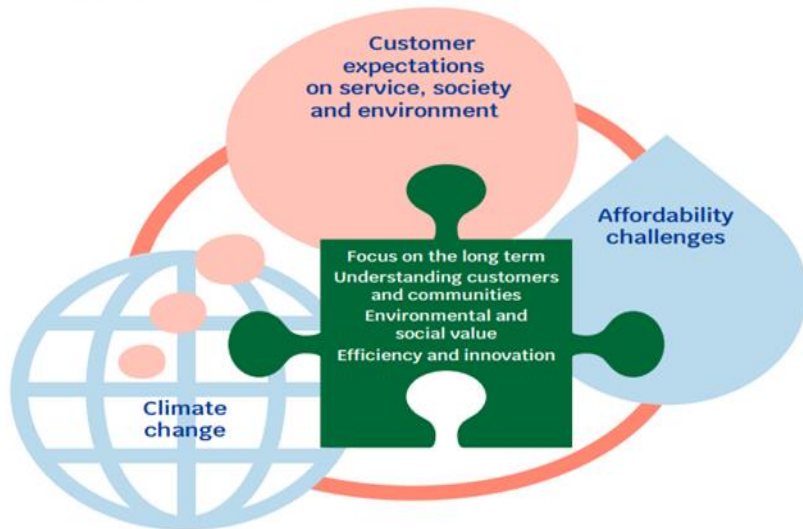
## OFWAT High Level Consultation Themes



- PR24 will represent an evolution from the PR19 approach, rather than a major departure
- The biggest change in emphasis is the focus on PR24 as part of a longer-term strategy
- In funding terms, Companies expect PR24 to be no less challenging than PR19

# Ofwat wants long term strategies to inform PR24

## Challenges and solutions



## Long-term delivery strategies: key common requirements (draft)

### 1. Long-term ambitions – where will the company be in 25 years?

Including indicative common performance commitments up to 2050, backed by customer evidence and/or government priorities

Long-term delivery strategy for 2025-2030 feeds directly into PR24 business plan

### 2. Strategy – how will you get there?

Including key enhancement investments up to 2050, set out as adaptive pathways with alternative options and trigger points

### 3. Rationale – why is the strategy the right way to meet long-term ambitions?

Evidence that the strategy delivers optimally in the short, medium and long term

### 4. Foundations – what assumptions and processes are underlying the strategy?

Key assumptions behind the strategy and use of scenario planning to test options and demonstrate resilience




# We will be required to tell Ofwat how our corporate strategy will deliver for the short to long term




# Publicly committed goals align to our strategic plan on a page




Deliver AMP7 Performance & Regulatory Commitments by 2025



Deliver AMP7 Performance & Regulatory Commitments by 2025




100% renewables energy purchase by April 2021




Generate 24% of our renewable energy by 2025



Triple the rate of leakage reduction by 2030



Bills no more than 5% of income by 2030




Achieve 100% commitment to the Social Mobility Pledge by 2030



Prevent the equiv. of 4bn plastic bottles ending up as waste by 2030



Net Zero Carbon (operational) by 2030



Electrify the fleet or introduce alternative low carbon fuels + Plant 11m trees and 10,000ha of peatland by 2030



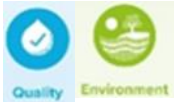
Achieve 100l/h/d by 2040




Zero Pollutions by 2040



Eliminating avoidable plastic waste before the end of 2042



At least 50% leakage reduction by 2050

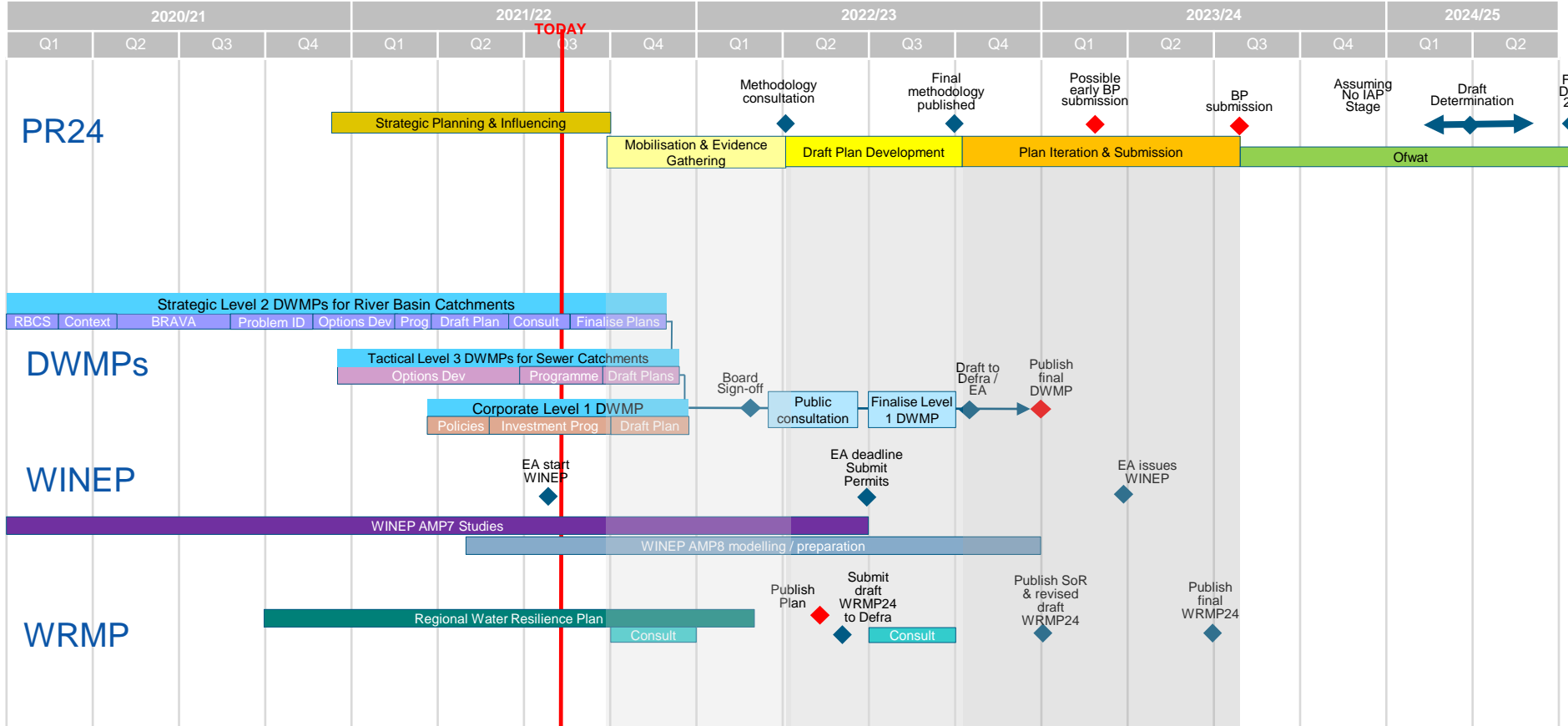


Net Zero Carbon by 2050



Note: 10% Biodiversity net gain for all future projects seems sensible to include before Env. Bill comes into force

# AMP7 Strategic Plan on a Page: PR24, DWMP, WINEP & WRMP all need to align and interact with each other for success

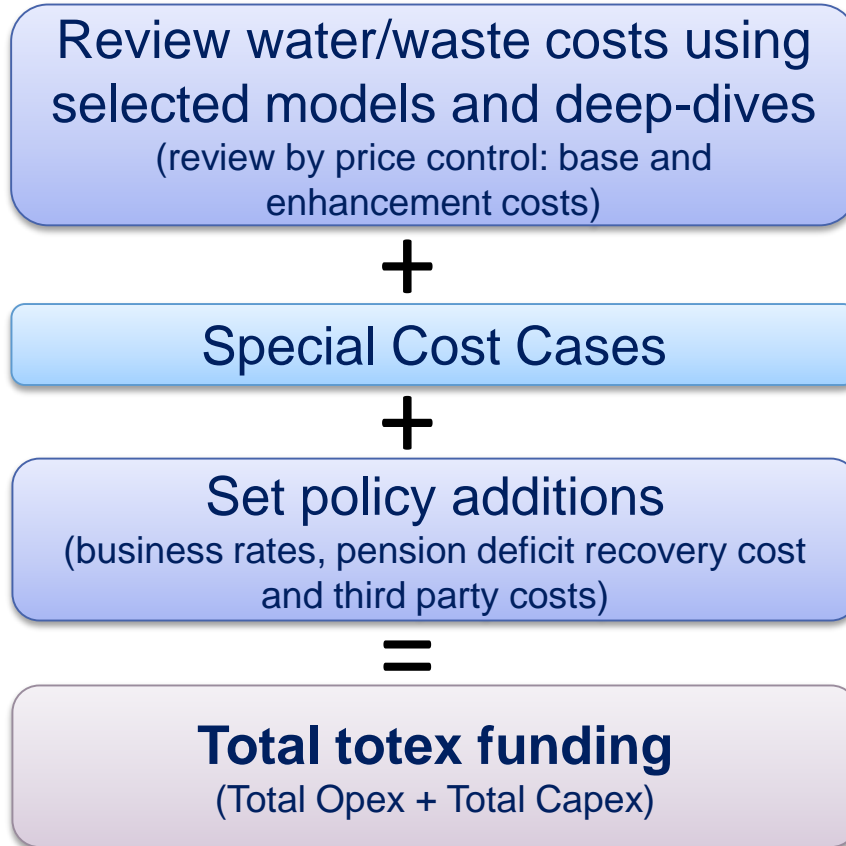


\*Timings, dependencies and milestone alignment are all subject to change as new info is provided

# Ofwat's Business Plan Assessment



# Ofwat assess investment proposals by Price Control using industry comparative modelling and deep-dives

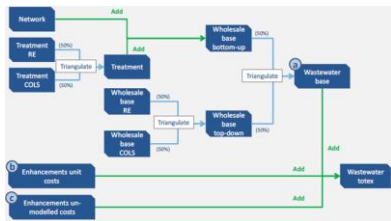


| Retail Price Control     |                 |
|--------------------------|-----------------|
| Wholesale Price Controls |                 |
| Water Resources          | Water Networks+ |
| Wastewater Networks+     | Bioresources    |
| Developer Services (TBC) |                 |



# Base activity: Cost of maintaining and operating existing assets to meet upper quartile performance and legal duties

## Ofwat



Ofwat use their own baseline “efficient” company model

+ Ofwat use comparative models based on company business plan & historic data

Ofwat model uses info from inside and outside the sector to create a picture of an ‘efficient water company’

Water company modelled data includes: Base opex & capex running costs; No. treatment works; Population served; Properties; Network length; etc.

- Ofwat have tended to model baseline costs using current and historic datasets + inflation
  - This approach broadly assumes that the ongoing baseline running costs will be similar now and in future to the past
- Ofwat are reviewing whether to include a new ‘forward looking’ element to baseline models at PR24
  - This forward-look would account for future impacts of, for example, climate change on base maintenance and operating costs



# Enhancement activity: Investment that improves or enhances the current baseline operation of the company



Ofwat assess enhancement costs through a mix of comparative industry models and/or deep-dive assessments

| Enhancement Components   | Enhancement Examples  |
|--|---|
| New Supply / Demand Requirements   | WRMP; DWMP  |
| New Environmental Requirements   | WINEP   |
| New or Emerging Water Quality Risks or Tightening of Regulations   | Nitrates, Pesticides, Lead, Fluoride  |
| Other New Statutory or Regulatory Requirements   | Security Measures (SEMD); Industry Emissions Dir.                               |
| Customer Supported Improvements – Special Cost Cases   | Bathing Waters to “Excellent” Status  |
| Level of Service Improvement Beyond Upper Quartile Performance – Special Cost Cases Supported by Customers | Improve Leakage beyond 15% reduction;<br>Leading on Pollution Reduction... Etc. |

Enhancement deep-dives and special cases have a high evidence threshold, and must have:

- ✓ A clear need
- ✓ Clear efficient cost of delivery
- ✓ Customer support – Including a clear willingness to pay extra for it
- ✓ Clear cost benefit + proven environmental & social value
- ✓ Customer protection from non-delivery or significant underspend

# Ofwat incentivise good performance and penalise bad performance through outcome deliver incentives (ODIs)

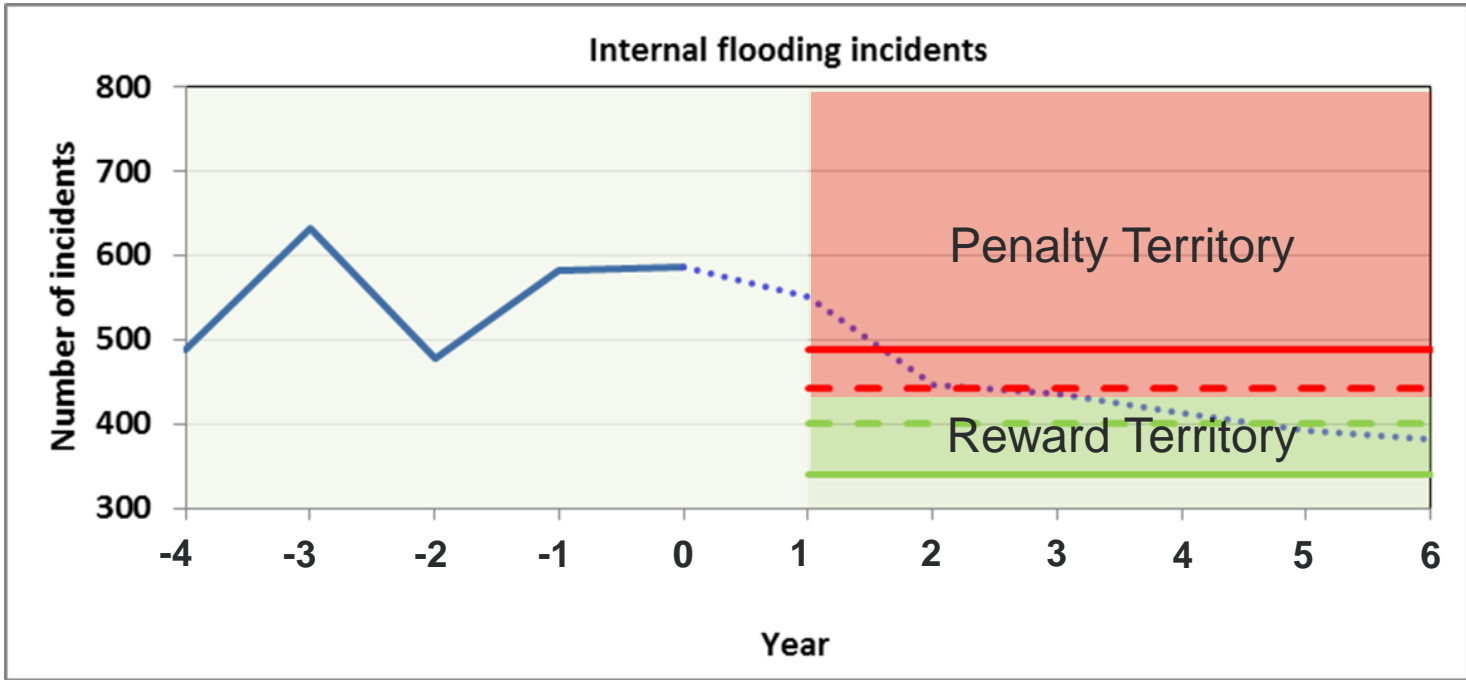
- **Performance commitments:** pledges companies make to their customers and stakeholders about service levels to make progress towards their outcomes.
- **Outcome delivery incentives:** financial or reputational consequences for companies of outperformance or underperformance against each commitment
- **Common performance commitments:** performance commitments with common definitions covering customers' key priorities and stretching performance levels

| Water  | Customer  | Wastewater   |
|--|---|--|
| Leakage; Mains repairs; Unplanned outage; Supply interruptions; Water quality compliance (CRI); Per capita consumption; Risk of severe restrictions in a drought | Priority services for customers in vulnerable circumstances; C-MeX; D-MeX | Internal sewer flooding; Pollution incidents; Risk of sewer flooding in a storm; Sewer collapses; Treatment works compliance |

- **Bespoke performance commitments:** reflect individual companies' circumstances and customers' preferences – E.g. Drinking water appearance; WINEP delivery; Bathing waters; Renewable generation; Natural capital etc.



# ODI Example – Internal Flooding Incidents



# Getting the balance right – Ofwat, with government backing, will only allow water bills to go so far to pay for things

- We can achieve a lot – But we can't do everything!
- Water companies are embracing opportunities to reduce cost and maximise benefits for customers and stakeholders:
  - **Innovation** and **nature based solutions** offer opportunities to deliver better performance, environmental and social benefits for less cost
  - **Partnerships** and **collaborations** provide an opportunity to pool resources to achieve greater environmental and social benefits
  - New **Commercial** ventures provide opportunity too (e.g. circular economy)
- Markets – Ofwat required to look at market opportunities to drive cost and performance improvements



# Price review process ends with a Final Determination from Ofwat – Companies either accept or appeal

- Following the Final Determination, companies have to decide if they can deliver on:
  - Their statutory and regulatory duties
  - The performance levels set out
  - Financeability measures – Risk and reward for investors
  - Customer and stakeholder expectations
  - Future resilience requirements
- Companies **accept** the Final Determination in its **entirety** or they have to appeal via the Competition & Markets Authority (CMA)

Ofwat



# Companies still have difficult delivery and funding choices to make before and after Final Determination

## Pre-Final Determination planning and delivery:

- Ofwat will allow some level of base maintenance and regulatory funding – For these more certain elements we can get on with efficient planning and delivery
- Customer supported, or less certain, funding requests may not commence delivery until the Final Determination is received (Go:No-go decision required)



## Post Final Determination planning and delivery:

- Tough decisions are made on how funding gaps will be met
- Cost, risk or performance – Something usually has to give
- After Final Determination it is all about delivering in the most cost beneficial and efficient way possible – Companies are always open to new ideas on delivering this!



from  
Southern  
Water



# Your Involvement in PR24

# The next 9-12 months are the most critical for getting needs, options and costs into our PR24 business plans

- Engage with us now on:
  - Our strategic plans – DWMP and WRMP consultations need your input
  - Identifying future needs and requirements
  - Identifying solutions and options for resolving problems
  - Innovation and partnership opportunities
- If you do not engage now do not worry
  - Our door is always open to new opportunities to deliver cost beneficial solutions to problems
  - New needs always come in that we have to manage between Price Reviews – Available funding may be an issue though
  - There will always be another Price Review in 5 years time



Thank you and questions?

