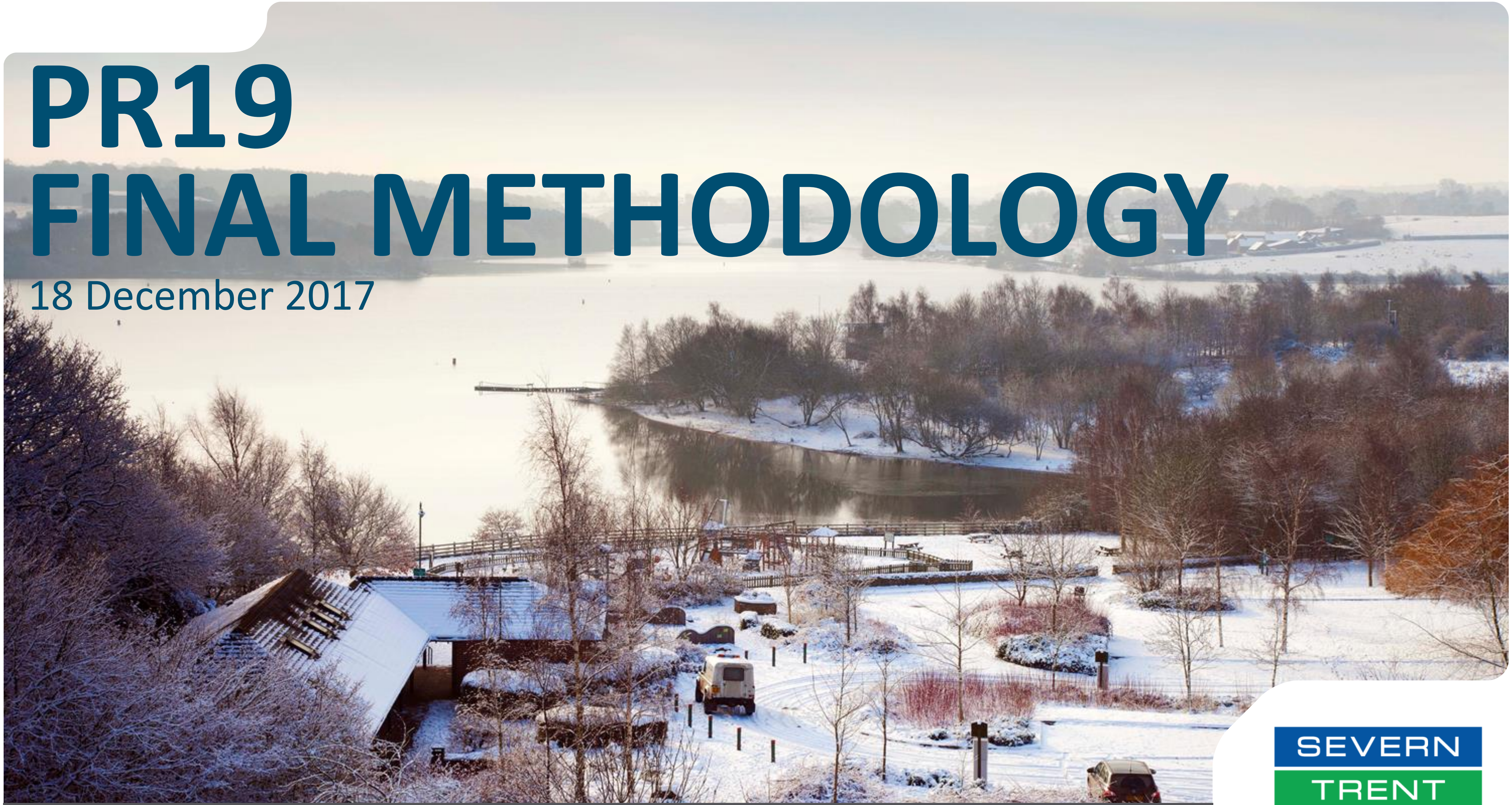
PR19
FINAL METHODOLOGY

18 December 2017



Draycote Water, Warwickshire

SEVERN TRENT

AGENDA

- Our thoughts on PR19
- Areas of specific interest
- Momentum into AMP7
- Levers of outperformance
- Timeline & Conclusions
- Q&A

Liv Garfield
Chief Executive

Shane Anderson
Head of Economic Regulation

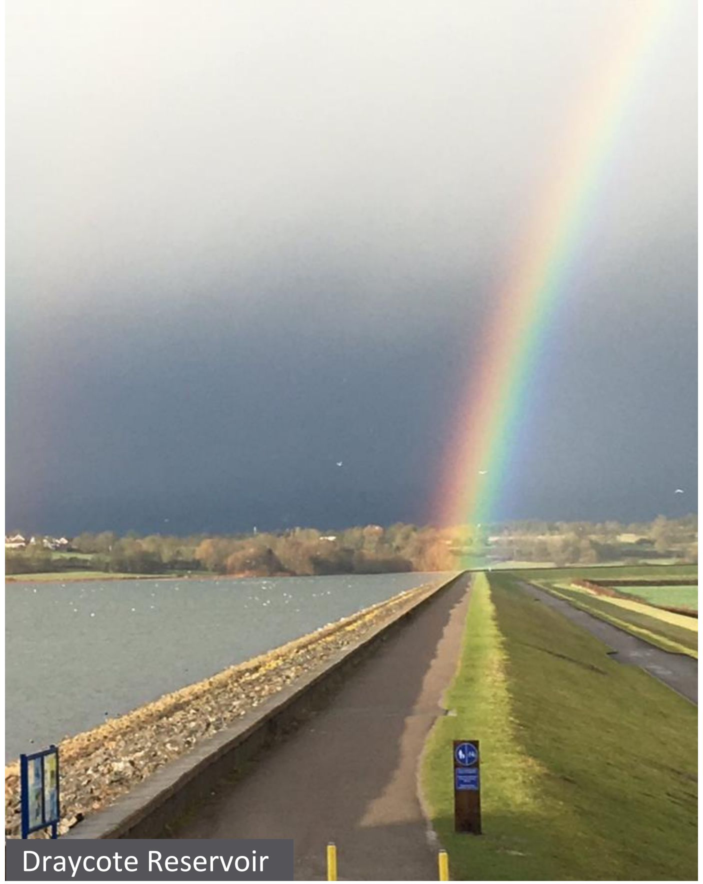
PR19 FINAL CONSULTATION DOCUMENT OUR THOUGHTS

- We expected it to be a **tough settlement,** and as such we do not see it as a surprise
- Methodology should be seen as a **settlement 'in the round'**; with WACC(1) being only one part
- We have been **preparing** for this for some time. We anticipated a range of **WACCs**, of which 2.3%(3) was one such scenario
- Having digested the document our **plans remain unchanged** – we had already set the performance trajectory for the remainder of AMP6(2) to enable a smooth transition into AMP7(2)
- **Encouraged** that incentives will play a much greater role in company returns. We intend to be winners in a world of incentivisation
- AMP7 **notional gearing** of 60% was new news (our H1 17/18 gearing was 59.2%)

1. *WACC = Weighted Average Cost of Capital*
2. *AMP6 = regulatory period 2015-2020, AMP7 = regulatory period 2020-2025*
3. *Wholesale WACC excludes Retail. Appointee WACC (including Retail) = 2.4%*

OUR VIEW OF THE INITIAL AREAS OF INTEREST

- WACC at 2.3% is **lower than the industry expected**. Accompanied by 60% gearing, this will be tough for the heavily geared companies in particular
- Ofwat have **retained their commitment** to incentivisation and actually increased the potential cash value of customer ODIs between the consultation and final methodology
- Ofwat are looking to create the right environment for the **right investment**:
  - Strong guidance for funding environmental requirements for National Environment Programme
  - Clearer guidance on assessing enhancement spend
- We have **excellent insights** on the future and more certainty on outperformance:
  - Retail – now on five year price controls
  - Retained commitment to econometric modelling
- There will be **winners and losers**. The winners will be rewarded:
  - New fast-tracked benefits revealed
- We have **four levers** to outperform above the base return:
  - Customer ODIs[1], totex, financing, and non-regulated business growth



Draycote Reservoir

1. *ODIs = Customer Outcome Delivery Incentives, quoted pre-tax at 2012/13 prices*

CATEGORISATION OF BUSINESS PLANS

- Ofwat has confirmed that there will be **four categories** for company business plans
  - Exceptional
  - Fast-track
  - Slow-track
  - Significant scrutiny
- They have provided **incentives** for business plans which are fast-track or exceptional

Financial benefits – exceptional

- Benefit equivalent to 20-35 basis points on RoRE(1)

Financial benefits – fast-track

- Benefit equivalent to 10 basis points on RoRE

Procedural/reputational benefits – exceptional and fast track

- Gain early certainty on costs and outcomes

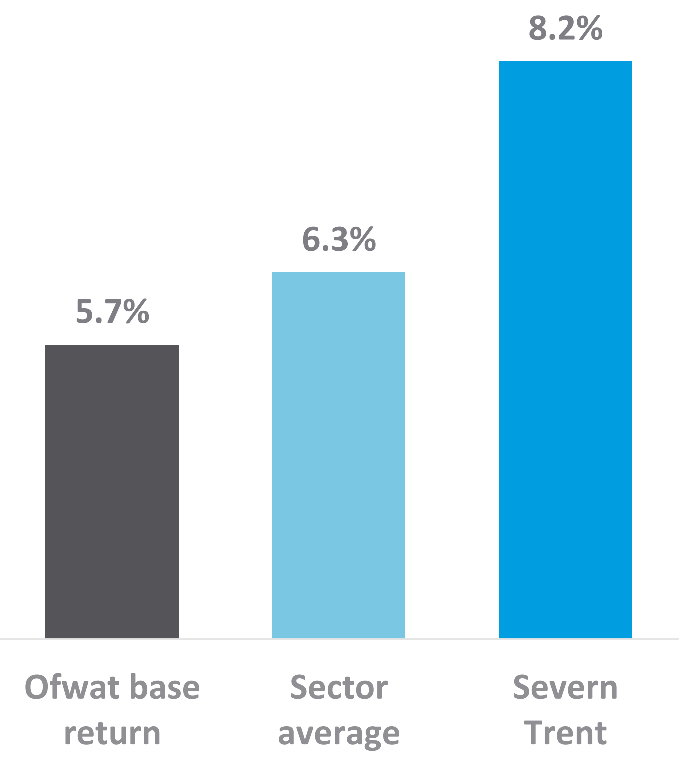
Business plans categorised as significant scrutiny will receive reduced cost sharing rates and potentially capped customer ODI payments

1. RoRE = Return on Regulated Equity (at 2012/13 prices)

AMP6 MOMENTUM INTO AMP7

- Created a track record of strong outperformance above the base return in AMP6
- We expected base returns would reduce; focused on creating a culture of outperformance for customers
- Proved we can achieve significant operational improvements in a short time window
- Embedded a culture of performance and customer focus in the business (comm cells, bonus, UK Customer Service Index score)
- Already restructured the business to get ourselves into the right shape for AMP7
- Sold non-core businesses and as such have focused management attention on the key areas of the business for the future
- Doubled our investment in R&D[2] two years ago and can see that bearing fruit
- Adopted digital technology early which will help our competitive position in the sector
- Strong track record created of landing financial savings simultaneously with operational improvements

Cumulative RoRE[1]
Years 1&2 of AMP6
(Ofwat definition)



1. *RoRE = Return on Regulated Equity (at 2012/13 prices), as taken from Company Annual Performance Reports*
2. *R&D = Research & Development*

LEVER 1: CUSTOMER ODIs[(1)]
STRONG ABSOLUTE PERFORMANCE

Final methodology insights

- Commitment to removing outperformance payment cap[(2)] (set at 2% of RoRE this AMP)
- Retained indicative RoRE range of +/- 1 to 3%
- Comparative metrics set to upper quartile (UQ) each year instead of a target based on 2024/25 UQ in year 1
- Compliance Risk Index (CRI) excluded from comparative UQ assessment
- New customer service measure (C-Mex) to replace SIM[(3)] with reward range increased from 6% to 12%
- Customer ODIs worth more in cash terms due to reduction in notional gearing

Opportunities

- ODIs have been good for Severn Trent and its customers
- Significant investments and operational changes have allowed us to improve in areas where customers value it most
- Changes across the company have led to £71m[(1)] outperformance payments in first two years of AMP6
- Only company this AMP predicted to be limited by ODI cap[(2)]
- We've done this by instilling a sharper performance culture in the company through comm cells, all employee bonus scheme, investment in R&D and innovation
- Encouraged by the move to UK CSI and expanding the incentive range

☆

- Strong customer ODI performance has created a platform for AMP7 outperformance
- To moderate bill increases we are proposing to smooth some earned outperformance payments into future periods
- The deferral of payments to future periods also creates a more stable earnings profile

1. *ODIs = Outcome Delivery Incentives, quoted pre-tax at 2012/13 prices*
2. *For AMP6, our customer ODI outperformance payments for Waste are capped at £190m (pre-tax at 2012/13 prices). To the end of 2016/17, we had earned £75m from our Waste customer ODIs, leaving £115m remaining*
3. *SIM = Service Incentive Mechanism*

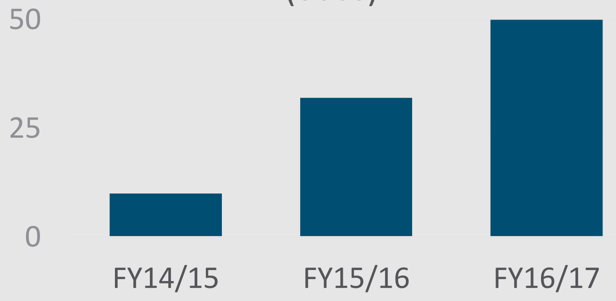
LEVER 1: CUSTOMER ODIs
EMBEDDED PERFORMANCE CULTURE

We don't yet know what the AMP7 customer ODIs will look like, however we back ourselves to perform
Below are three indicative examples where we have turned around performance

Retail

- We now assist more than 50,000 vulnerable customers
- At the start of AMP6 we catered for ~10,000 vulnerable customers

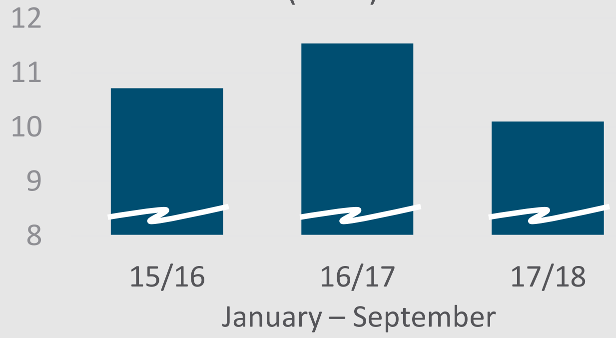
Vulnerable customers helped (000s)



Water

- We've worked hard and seen a 12% improvement (1.4k fewer instances) in water quality complaints[1] in January to September 17/18

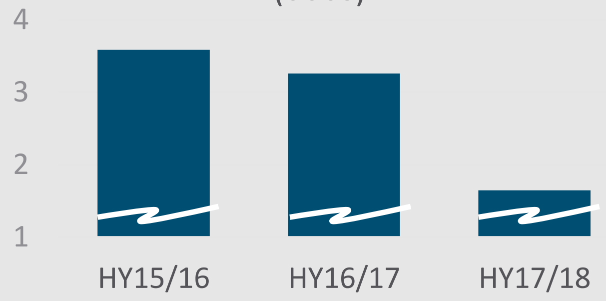
Water quality complaints (000s)



Waste

- Increased investment and operational improvements resulted in a 50% reduction in external sewer flooding[1] in H1 17/18 alone

External sewer flooding (000s)

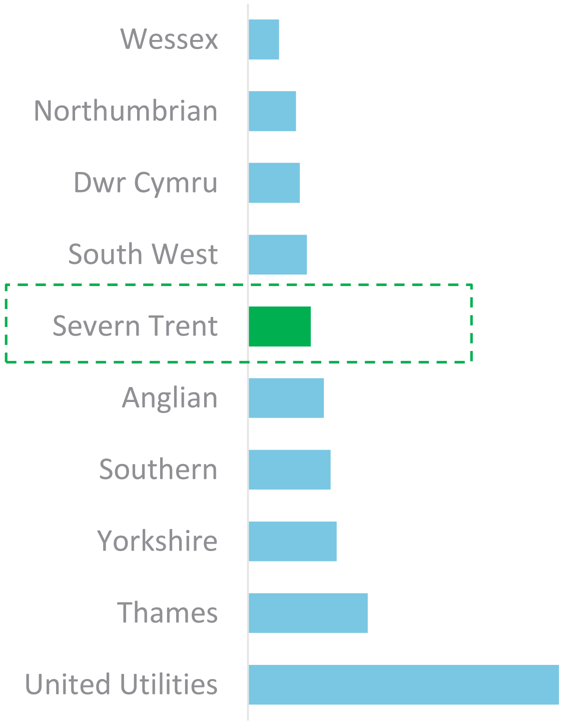


1. ODI measure

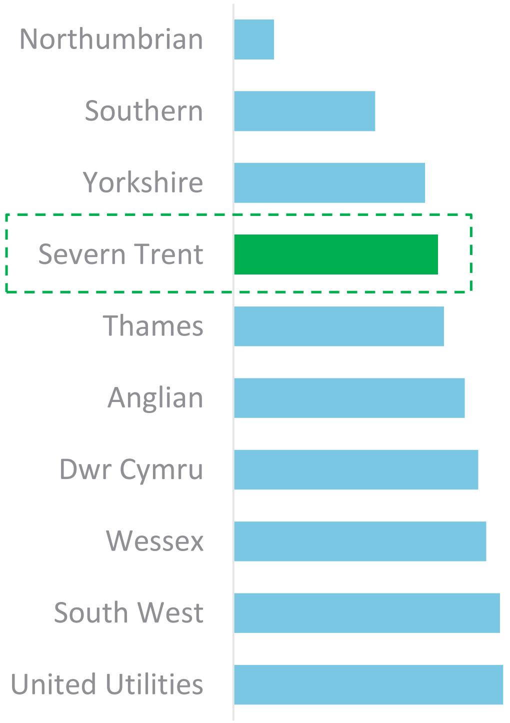
LEVER 1: CUSTOMER ODIs
STRONG COMPARATIVE PERFORMANCE

We've created a good platform to succeed, but there is more to be done

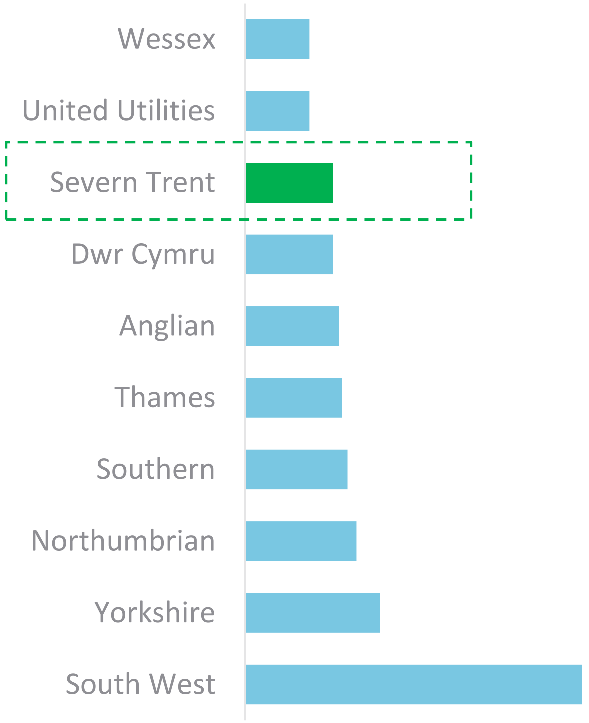
Internal sewer flooding
(per 10,000 connections to sewers)



Supply interruptions*
(per total properties served)



Pollution incidents
(per 10,000 km of sewers)



***Source: Discover Water** (https://discoverwater.co.uk/)*

** 2017/18 performance expected to fall due to a number of large incidents*

LEVER 2: TOTEX SAVINGS THROUGH INNOVATION

Final methodology insights

- Econometric modelling for water and waste confirmed with strong efficiency challenge and no capping
- Fewer cost exclusions with high evidentiary bar
- Strong commitment for funding environmental requirements for National Environment Programme
- Retail allowance to be set using econometric modelling with stronger efficiency challenge, although econometrics strengthens incentives for high performance – e.g. bad debt
- Retail – five year control (not three years) means we retain outperformance for longer
- Bioresources – similar to retail, companies retain all efficiencies before prices reset at PR24[3]

Opportunities

- Our senior management team is from a variety of sectors, bringing new and innovative ways of thinking, including using econometric modelling to identify opportunities for efficiencies
- Creating an efficient business in AMP6: using innovation and technology we've identified £770m AMP6 efficiencies[1] (86% locked in)
- Recognise that AMP7 challenge will be tough but we have the right team to continue delivering efficiencies and keep bills the lowest in England and Wales
- Top performing WASC[4] for bad debt at 1.8%
- Bio-resources has been carved out for greater opportunity

☆ Options remain to deliver greater cost efficiency, through adoption of technology, in-sourcing of staff, materials management, and the effects of our recent re-organisation

1. *Efficiencies shown in nominal prices*
2. *Net outperformance = £770m total efficiencies, with £410m required to meet Final Determination, and £120m committed reinvestment*
3. *PR24 = Price Review for period 2025-2030*
4. *WASC = Water and Sewerage Company*

LEVER 3: FINANCING
REBALANCING THE PORTFOLIO

Final methodology insights

- Retained scope for financing outperformance but new rules make it much harder
- Significant reduction in AMP7 WACC to 2.3% (2.4% including Retail)
- Notional gearing of 60%. We are at 59.2% at HY17/18
- Embedded debt allowance of 4.6% based on median performance (nominal)
- Indexation of the cost of new debt removes some opportunity to outperform, but also reduces risk
- Confirmed adoption of CPI-H for indexation

Opportunities

- We back ourselves to deliver with a dynamic treasury function who scour the markets for opportunities
- Confident of ending AMP around notional level
- Embedded debt – delivered a 90bps reduction in financing cost during AMP6 to 4.5% at H1 2017/18, despite higher RPI
- Already achieving the embedded debt assumption with more refinancing to come
- New debt – proven track record of efficient financing in AMP6
- Started repositioning debt for introduction of CPI-H by executing £150m of forward-dated RPI:CPI swaps
- Successful strategy to rebalance portfolio means we are well positioned for AMP7

☆

- The water sector has received criticism for high levels of gearing and poor visibility of corporate structures
- As a FTSE listed PLC, good governance and transparency are central to how we operate
- Our performance is underpinned by operational excellence and customers getting value for money

LEVER 4: NON-REGULATED OPPORTUNITIES DRIVING PROFITS

- Growth in non-reg activity – HY17/18 profits up 22%. Enhances group profitability by ~£30m per annum
- Refined portfolio of non-reg businesses during AMP6 – now aligns to our core strengths and long-term strategic goals
- By self generating ~40% of our energy we avoid sector-wide pass through costs making our business more competitive

Property Sales

- c.£100m PBIT to be delivered over next 10 years, at between £5m – £15m each year

Renewable Energy

- Further opportunities to increase our energy generation through food waste and crop anaerobic digestion, solar and hydro. ~20% → 50% self-gen in AMP6

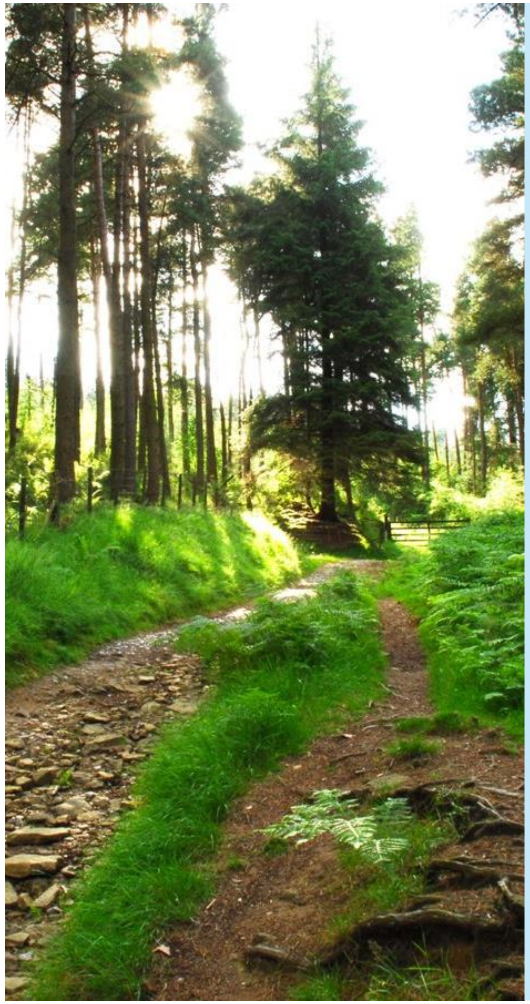
Non-reg activities provide broader benefits for our customers, communities, the environment, and investors

- Property sales:
  - free up land for house building, helping the housing shortage
  - help keep customer bills low, through the RCV adjustment
- Renewable energy programme contributes towards the Government's aim to decarbonise the UK economy

FORWARD TIMELINE

Key dates	
January 2018	Companies **submit** Water Resources RCV allocation
3rd May 2018	Companies **submit** performance commitment definitions, and details of cost adjustments
3rd September 2018	Companies **submit business plans** to Ofwat
Late January 2019	Ofwat published **initial assessment** of business plans
March/April 2019	**Draft determinations** published for exceptional and fast track plans
July 2019	**Draft determinations** published for slow track and significant scrutiny plans
December 2019	**Final Determinations** published

CONCLUSIONS



- Expected PR19 to be a tough settlement and prepared for a range of outcomes, including 2.3% WACC
- Methodology sets out a clear focus on strengthening incentive-based regulation and we have good momentum to benefit from this
- Non-regulated business is growing strongly and we see further opportunities ahead
- Track record of amplifying outperformance moved us from a position of <1.0X dividend cover[1] at the start of AMP6 to >1.4x at HY17/18
- There is much more to do but we have the ambition and ability to perform on areas of value across the business

1. *Dividend cover measured as underlying earnings ÷ dividends payable*

Q&A

Liv Garfield
Chief Executive

Shane Anderson
Head of Economic Regulation

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