

# 2019 PRICE REVIEW UPDATE

*14 JULY 2017*

*Tittesworth Reservoir, Staffordshire*

SEVERN  
TRENT

# AGENDA

- Overall approach
- PR19 'new news'
- Customer ODIs<sup>(1)</sup>
- Totex
- Retail
- Financing
- New markets
- PR19 Timetable
- Summary



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1. ODI = Outcome Delivery Incentives

# OVERVIEW

## METHODOLOGY CONTINUES TO SUPPORT WINNERS IN A WORLD OF INCENTIVISATION

- PR19 methodology represents a very challenging regime, as we predicted
- Putting customers at the heart of all we do is one of our key strategic priorities - this is deeply embedded in the methodology. There is a clear requirement for companies to innovate to deliver better customer service in AMP7
- We are particularly supportive of Ofwat's proposals to:
  - Strengthen the customer ODI framework with the removal of the 2% cap on ODI outperformance (indicative range of  $\pm 1\%$  to  $\pm 3\%$  of RoRE<sup>(1)</sup>)
  - Sharpen incentives for innovation through uncapping and increased cost sharing percentages
  - Reward high-quality business plans
- We've supported much of this in *Charting a Sustainable Course*

CHARTING A  
SUSTAINABLE  
COURSE



# OVERALL APPROACH

## Nine tests

1. Engaging customers
2. Addressing affordability and vulnerability
3. Delivering outcomes for customers
4. Securing long-term resilience
5. Targeted controls, markets and innovation
6. Securing cost efficiency
7. Aligning risk and return
8. Accounting for past delivery
9. Securing confidence and assurance

## Four categories of plan

### Exceptional

High-quality plans with significant ambition and innovation for customers

### Fast track

High-quality plans. Do not require material intervention, but are not ambitious/innovative enough to attain exceptional status

### Slow track

Material interventions are required in some areas to protect the interests of customers

### Significant scrutiny

Fall well short of the required quality. Major interventions are required to protect the interest of customers

Our PR19 preparation is underway with a strong ambition for a high-quality plan

# “NEW NEWS”

## Customer ODIs

- Significant kick-up in rewards for top performing companies
- 14 common ODIs proposed of which four are comparative
- Smoothing of rewards proposed
- Bolder leakage targets planned

## Totex

- Uncapping of model; enhances incentive regime
- Potential for companies to retain a higher percentage of outperformance

## Retail

- Transition from average cost to serve to econometric modelling of efficient costs
- Performance now based on upper-quartile ranking

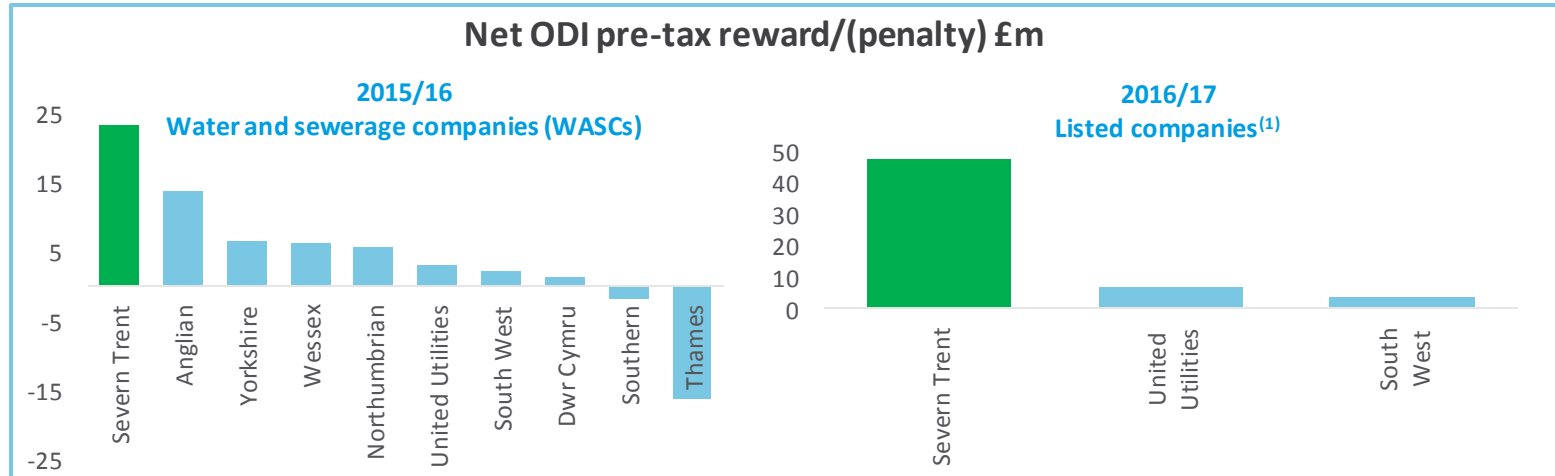
## Financing/WACC

- CPI-H confirmed as new indexation basis
- WACC still expected in December

# CUSTOMER ODI<sub>s</sub>

## EVOLUTION OF CUSTOMER ODI<sub>s</sub>

- ODIs will be worth more to companies; removal of the 2% cap on ODI outperformance (indicative range of **±1% to ±3%** of RoRE)
- Targets are likely to be challenging
- Our comparative performance in the first two years of the AMP has been encouraging
- **We have embraced the ODI regime and it is ingrained in our organisational culture**



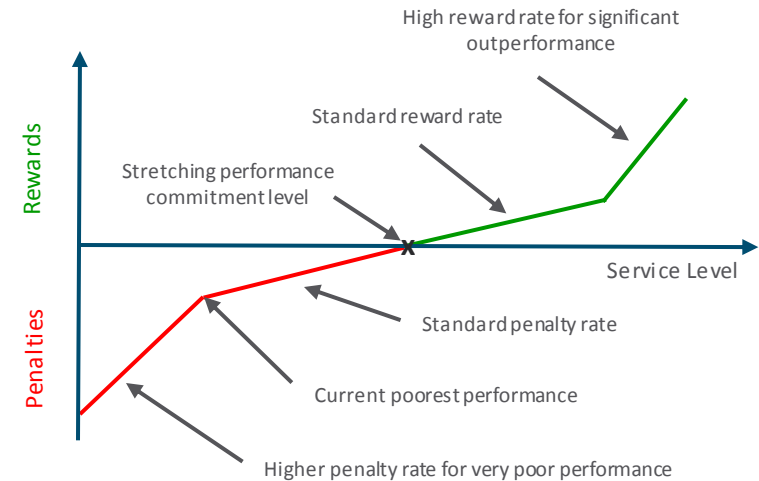
1. Listed companies only as data for other companies is still to be published by Ofwat

# CUSTOMER ODIs

## EVOLUTION OF CUSTOMER ODIs

- There are 14 common PC<sup>(1)</sup>/ODIs
  - Scope for **'super charging' of rewards** for upper quartile performance on these measures<sup>(2)</sup>
- Four of the common PC<sup>(1)</sup>/ODIs have comparative assessments:
  - Water quality compliance
  - Internal supply interruptions
  - Internal sewer flooding
  - Pollution incidents

### Illustration of proposed enhanced reward and penalties at PR19<sup>(3)</sup>



1. Performance commitments  
2. Excludes resilience measures  
3. Source = Ofwat



# CUSTOMER ODI<sub>s</sub>

## NEW MEASURES OF CUSTOMER SERVICE

- Ofwat has identified relatively low levels of customer satisfaction
- It has proposed to replace SIM<sup>(1)</sup> with a new customer satisfaction measure (C-MeX) - this will be based on two surveys:
  - Sample of customers who have contacted their water company (50%)
  - Sample of customers who haven't contacted their water company (50%)
- Unlike SIM, C-MeX will have symmetrical incentives with the maximum rewards doubling from 6% to 12% of retail revenues
- However access to the 6 to 12% reward range requires companies to perform at or above a threshold based on UKCSI

**UK Customer Satisfaction Index (UKCSI) – Utilities**  
 Severn Trent achieved 5<sup>th</sup> out of 25 utility companies in the survey, after improving performance by 4 points over the past year

1. SIM = Service Incentive Mechanism

**UK Customer Satisfaction Index - Utilities**

		July-17 UKCSI
	Utilities average	75.1
1	Energy company	81.8
2	Water company	80.4
3	Water company	79.8
4	Energy company	79.5
5	<b>Severn Trent Water</b>	<b>78.8</b>
6	Water company	78.6
7	Energy company	78.3
8	Water company	78
9	Energy company	77.1
10	Water company	77.1
11	Energy company	76.2
12	Energy company	75.8
13	Energy company	75.5
14	Energy company	75.3
15	Energy company	75.1
16	Water company	75
17	Water company	75
18	Energy company	74.8
19	Water company	74.5
20	Water company	73.3
21	Energy company	72.8
22	Water company	72.5
23	Water company	71.5
24	Energy company	70.1
25	Energy company	69.7



# CUSTOMER ODI<sub>s</sub>

## GREATER ROLE FOR IN-PERIOD ODI<sub>s</sub>

- No cap, indicative RoRE<sup>(1)</sup> range of +/- 1 to 3%
- In-year rewards and penalties:
  - Emphasis on revenue, with PBIT<sup>(2)</sup> upside rather than RCV<sup>(3)</sup> adjustments
  - Scope to smooth some customer ODI rewards into future years to reduce impact on customer bills, and deferred amount will be adjusted for financing costs (WACC)
  - We are analysing bill profiles from AMP6 to AMP7, to inform AMP6 ODI smoothing - this will give Severn Trent some further visibility of the ODI profile in AMP7

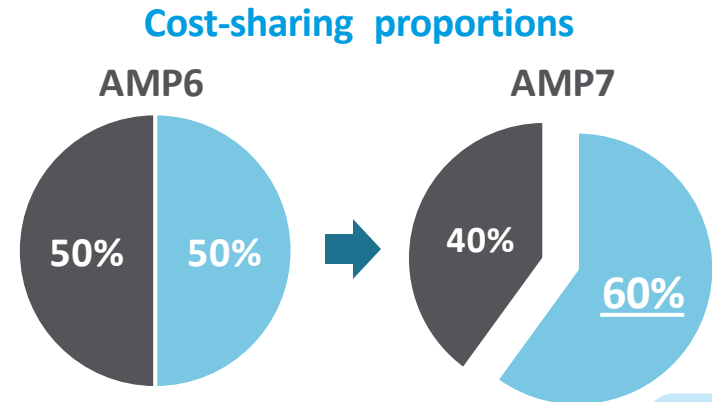
• **ODI reward/penalty:** the plausible maximum ODI reward or penalty would have around a £20 impact on the 2015-16 average combined household bill. In a reward scenario, this would require particularly strong performance across all ODIs across each of the price controls. As discussed in the Delivering outcomes for customers chapter, **we expect companies to consider bill smoothing to protect customers against undue bill volatility.** For an average size water and sewerage company, the bill impact would equate to around £45 million on an annualised basis.

1. RoRE = Return on Regulated Equity  
2. PBIT = Profit Before Interest and Tax  
3. RCV = Regulatory Capital Value

# TOTEX

## PUSHING FOR FRONTIER

- The cost modelling draws on PR14 and uses historic data to calibrate the models, but also includes a dynamic efficiency challenge
- This means companies will need to
  - i. Catch-up if they are behind the efficiency benchmark
  - ii. Continue to innovate and become more efficient
- **There are however stronger incentives for innovation if companies can get into the upper quartile**
- No capping – At PR14, if a company's plan was below Ofwat's cost models, it capped the difference to 5%. **For waste this intervention reduced our cost allowance before sharing by well in excess of £100m.** Ofwat has confirmed it does not intend to apply a cap as it can reduce the incentives to innovate
- Greater cost sharing – The new cost sharing incentive means companies can retain up to 60% of outperformance if they are very efficient

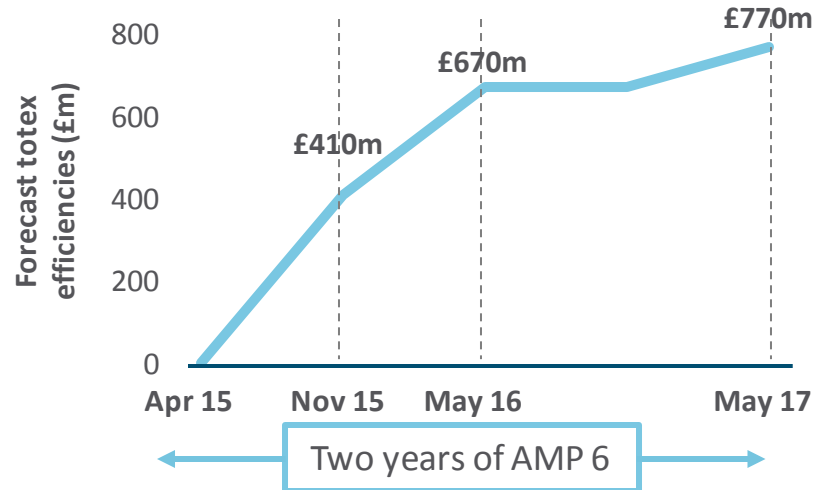


# TOTEX

## WHOLESALE OPPORTUNITY

- We have performed well with **£770m** total AMP6 efficiencies:
  - £120m elected to be reinvested for the benefit of customers
  - £240m net outperformance

### Totex efficiencies: progression through AMP6



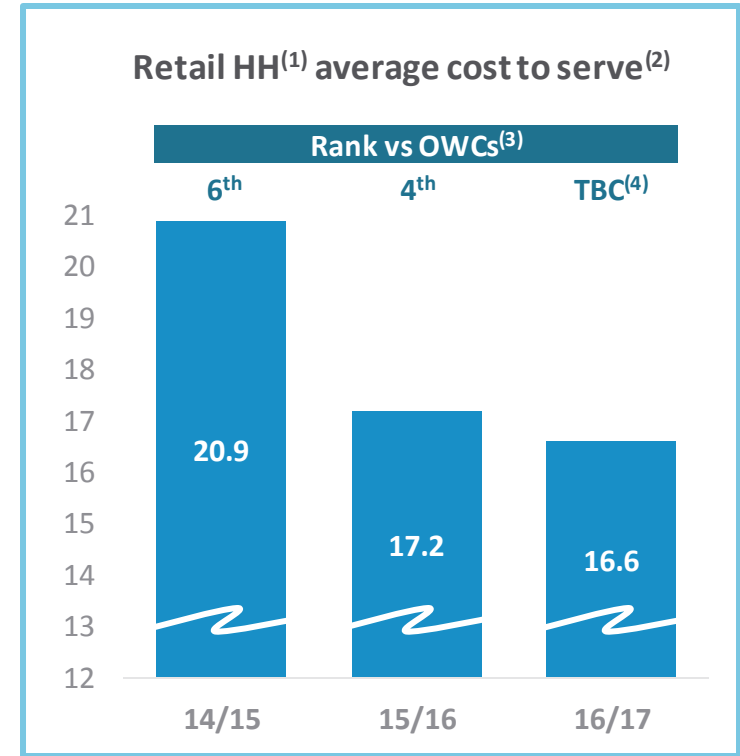
#### Initiatives to continue this journey in AMP7:

- Insourcing
- Material management
- Adoption of technology

# RETAIL

## COST SETTING

- PR19 moves away from average cost to serve and moves to econometric modelling of efficient costs
- Our retail household cost to serve has reduced each year so far in AMP6 and is at a lower level than in 2014/15
- **We get to keep 100% of cost outperformance**
- This performance is driven by innovation where both the business and the customer benefits – examples include:
  - Our customer driven bill format has reduced the volume of unwanted customer contacts by 17%
  - Investing in a multi-channel customer contact offering – savings of £850k p.a.
  - Our new customer management portal – reducing call handling time by 3mins – savings of £330k p.a.



1. HH = Household

2. In £ per customer (excludes depreciation)

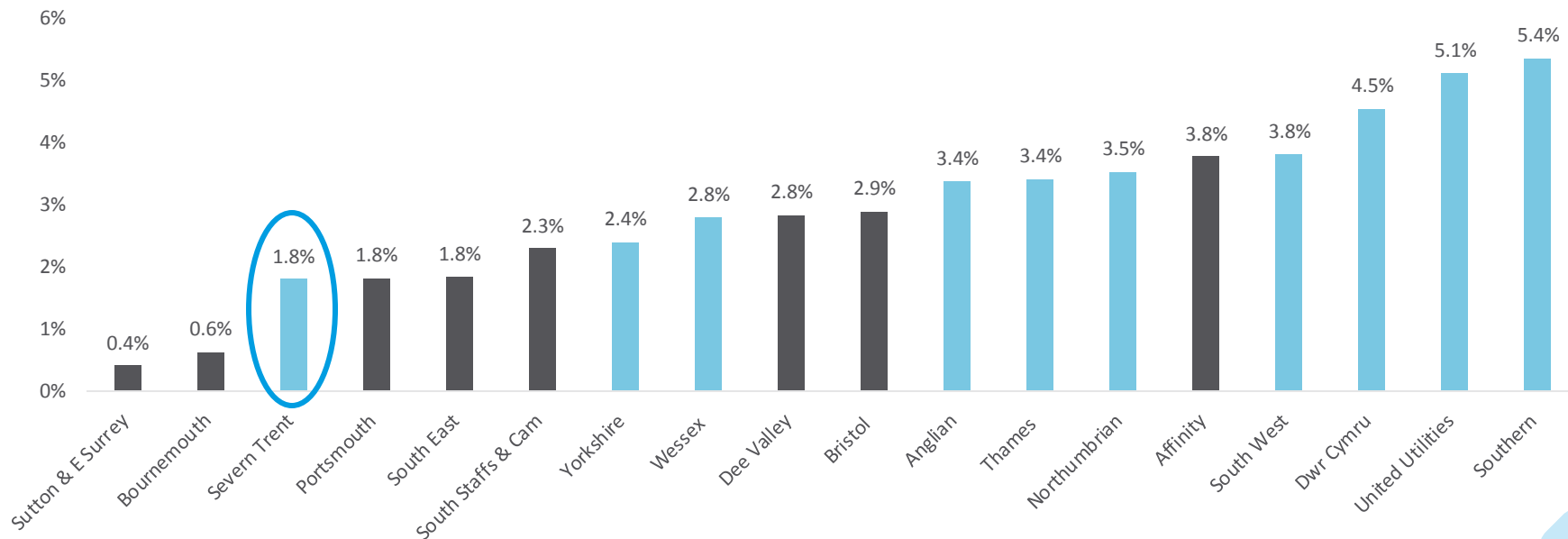
3. OWCs = Other Water Companies

4. Comparative data still to be published

# RETAIL BAD DEBT

Our bad debt performance is sector leading versus other WASCs<sup>(1)</sup> with only Sutton & East Surrey and Bournemouth outperforming us in 2015/16

Household bad debt % in 2015/16



1. WASC = Water and Sewerage Company

Source: water company Annual Performance Reports (APRs)

## FURTHER CLARITY ON NEW METHODOLOGY

- **Ofwat's December publication will set out a WACC position, but a number of elements are already clear**
- **Adoption of CPI-H for indexation**
  - Confirmation of CPI-H rather than CPI adoption
  - Revenues and cost assessment using CPI-H
  - Transition plan for RCV indexation; AMP7: 50% of pre-2020 RCV indexed to RPI, 50% of pre-2020 and all new RCV to CPI-H
  - Key point is that transition is NPV neutral
- **Risk of historical choices on capital structure remain with companies**
  - No mandatory sharing of financing outperformance

### WACC components:

- **Cost of equity**
  - Ofwat have indicated that the allowed cost of equity will be lower in AMP7
- **Cost of debt**
  - New debt indexed using iBoxx non-financials index for A and BBB credit ratings with tenor of 10-plus years
  - Embedded debt will have a fixed allowance based on industry and market benchmarks
- **Gearing**
  - Assumption unchanged at 62.5%
- **Tax**
  - True-ups at PR24 for any changes to corporation tax rates and capital allowances

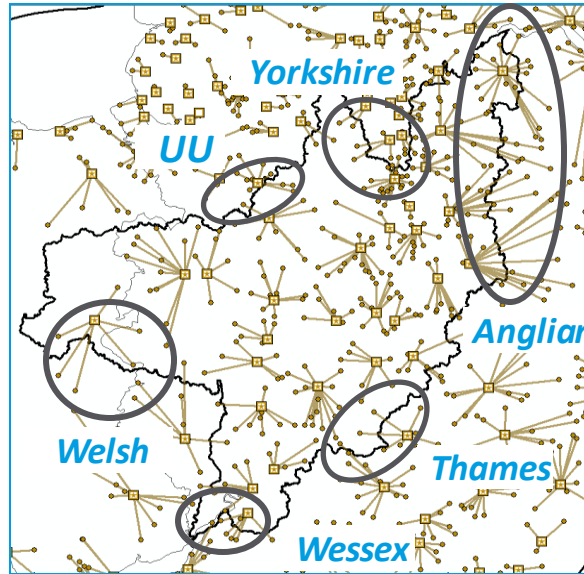
# DEVELOPMENT OF NEW MARKETS

## SEVERN TRENT WELL POSITIONED

### Bioresources

- One of the sector leaders in anaerobic digestion
- Our extensive borders with other water companies gives us an advantage
- Two way trading allows for revenue and totex saving opportunities by finding lowest cost solutions

### *Bioresource trading opportunities with neighbouring companies*



### Water resources

- Creating a market to address supply and demand imbalance
- We are supportive of this Ofwat proposal
- Our geographic location puts us in a good position to benefit



# PR19 TIMETABLE

## A CLEAR PROCESS AHEAD

### Three key dates:

#### Mid December 2017

Final PR19 methodology published including **first view of the WACC**

#### 3<sup>rd</sup> September 2018

Companies **submit business plans** to Ofwat

#### March/April 2019

**Draft determinations** for exceptional and fast track plans

- Vision to be the most trusted water company by 2020
- We will continue to engage stakeholders with a transparent approach
- AMP6 focus on the building blocks:
  - Putting customers first, delivering for our communities, colleagues and investors
- Planning well underway; almost three years until the start of AMP7

# CONCLUSIONS

- Ofwat has set out a challenging framework; but we knew it would be tough
- Companies need step changes in performance; challenging cost targets, bold customer commitments
- Base returns will reduce for AMP7
- Outperformance will be key for companies to offset the lower WACC
- We're well positioned in the sector:
  - We embraced the new incentive mechanisms and have a track record of delivery
  - We've been delivering for customers through AMP6
  - Innovation and technology are central to our thinking
- There will be winners and losers in the new regime – we intend to be winners

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