
PR14 Update From Severn Trent

Tony Wray – CEO

Mike McKeon – CFO

Dr Tony Ballance – Director of Strategy and Regulation

12th February 2013, 15:00 GMT

The background features several sets of concentric circles in a light blue color, creating a ripple effect. These circles are centered at various points on the right side of the slide, with some overlapping each other.

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Summary

PR14 will be different

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- But proposals are an evolution of the tried and tested industry framework
- No significant change to industry risk profile
- Increased customer engagement
- Changes are aligned with our own proposals

SVT is prepared for change

- Aligned to the PR14 methodology (water/waste/retail)
- Taking action - e.g. STCostain
- Below average cost to serve in retail
- Well placed to take advantage of opportunities

SVT is positive about changes

- Made good progress on PR14 plan
- More flexibility in delivery of plan & risk / reward appetite



We will update you again in the summer on our progress

Structure for this presentation



Why change?

Publications

Draft bill – an opportunity

PR14 Methodology

What does this mean for PR14?

Engagement

Affordability

AMP6 vs. AMP5 capital programme

Next steps

Retail

Wholesale

WACC

Investment*

Affordability*

*To be covered in a future presentation

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① Framework: Why change?

Whilst the existing framework has worked well, the industry is facing new challenges and change is needed to address them

① Framework ② SVT Progress ③ Conclusion

- Resilience and Security of Supply
 - Demand management
 - Better / more efficient utilisation of scarce resource – water
- Sustainability
 - Re-balancing of abstraction
 - Promotion of operational solutions – address capex bias
- Affordability
 - Prospect of declining real incomes and reform of welfare system
- No change not an option
 - Government proposing change
 - Economic regulator proposing change
 - Environmental regulators proposing change
 - Customers – demanding choice and affordability
 - Companies need to tackle new challenges

① Framework: Publications

① Framework → ② SVT Progress → ③ Conclusion

Ofwat



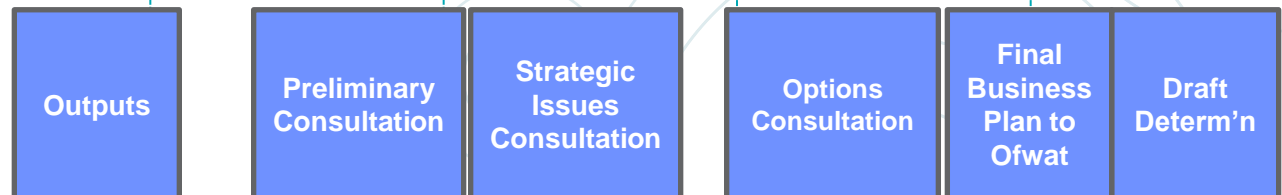
Government



Severn Trent



PR14 Process



① Framework: Draft Water Bill, an opportunity

① Framework

② SVT Progress

③ Conclusion

We're supportive of the measures to reform the industry:

Draft bill measure		Opportunity	Risk to manage
Increased non-household retail competition	➔	Opportunity for growth / value creation – Severn Trent Costain JV Market PBIT £7m-15m? Low cost to serve for household retail	Loss of market share. 5% of our business customers c. £1m PBIT p.a.
Upstream competition – Water trading	➔	Better use of resources, increased resilience, lower costs for customers Potential trading options – up to 200 or 300 MI/d over next 20 years	Identifying the right opportunities Getting right commercial model & incentives
	➔	More efficient water and waste water use. Opportunity to grow.	Operational asset stranding. Don't believe any RCV at risk
Reform of mergers & acquisitions regime	➔	More efficient industry structure	Identifying the right opportunities Ultimately 6-8 companies is probably the right structure

① Framework: Ofwat's PR14 methodology consultation

① Framework ② SVT Progress ③ Conclusion

	Wholesale Controls		Retail Controls				
	Water	Wastewater	Household	Non-Household (England)	Non-Household (Wales)	n/a for SVT	
Focusing on delivery	Enhances customer engagement		✓	Default level of service		✓ ?	
	Outcomes approach		✓				
	Outcome delivery incentives		✓ ?	SIM	✓	Service incentive	
Securing value for money	Menu-based cost performance incentives		✓ ?	Average cost to serve	Default tariffs		✓ ?
	Totex cost assessment		✓ ?				
	Totex cost recovery		✓ ?				Efficiency challenge
Using resources better	Water trading		✓ ?				
	AIM		✓ ?				
Mitigating risk	Interim determination (including substantial effect clause)					=	
	RPI indexation		=				
	Use of regulatory capital value (RCV)		=				
Revealing information	Network plus		?				
	Network management		?				

Key

✓ Supportive of changes

? Require more information

= Same as PR09

Key

- ✓ Supportive of changes
- ? Require more information
- = Same as PR09

① Framework: What does this mean for PR14?

① Framework

② SVT Progress

③ Conclusion

Measure

Benefit

Risk to manage

A

Separate controls for retail (hh & non-hh) and wholesale:

- RCV stays with wholesale
- hh retail based on average cost to serve



Greater incentives to focus on best customer services at lowest cost
More choice for non-household customers
SVT well placed on average cost to serve.



Devil is in the detail – average retail cost calculation

Definition of “retail” (what activities are in/not in)

B

Focus on outcomes



Focus on benefit to customers
Greater flexibility for innovation
Company ownership of plans



Getting the right balance

C

Fewer but high powered incentives



Regulation is focussed where it is most needed.



Devil is in the detail
Totex baseline
Companies become risk averse if penalties exceed positive incentives

D

Greater focus on customer and stakeholder engagement



Better level of challenge from customer challenge groups, better informed plans



Status of customer challenge groups in the price determination process yet to be properly defined by Ofwat

① Framework: What does this mean for PR14?

A Wholesale / Retail split

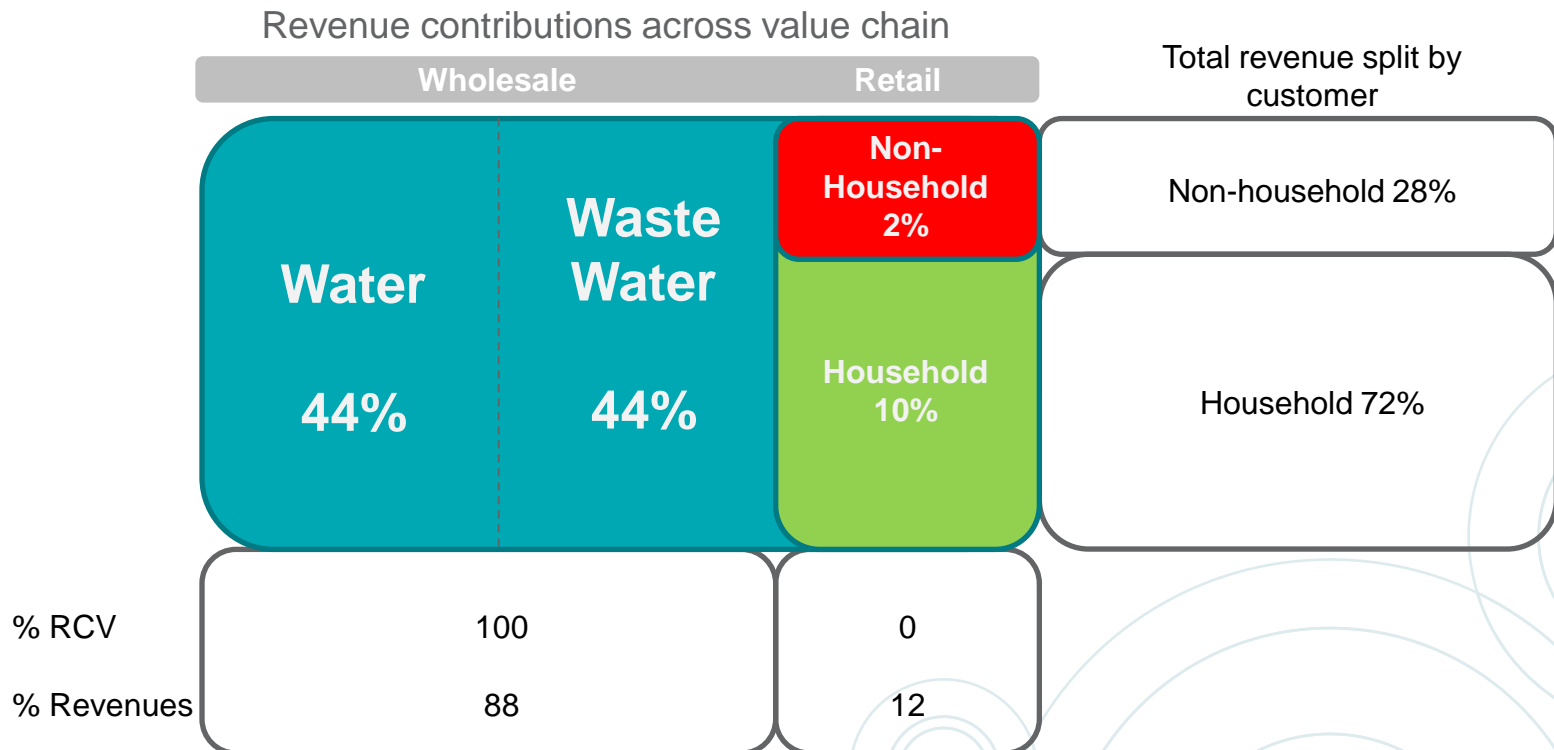
① Framework

② SVT Progress

③ Conclusion

Separate controls for retail and wholesale:

- RCV stays with wholesale
- Retail – price determined by average cost to serve and margin



① Framework: What does this mean for PR14?

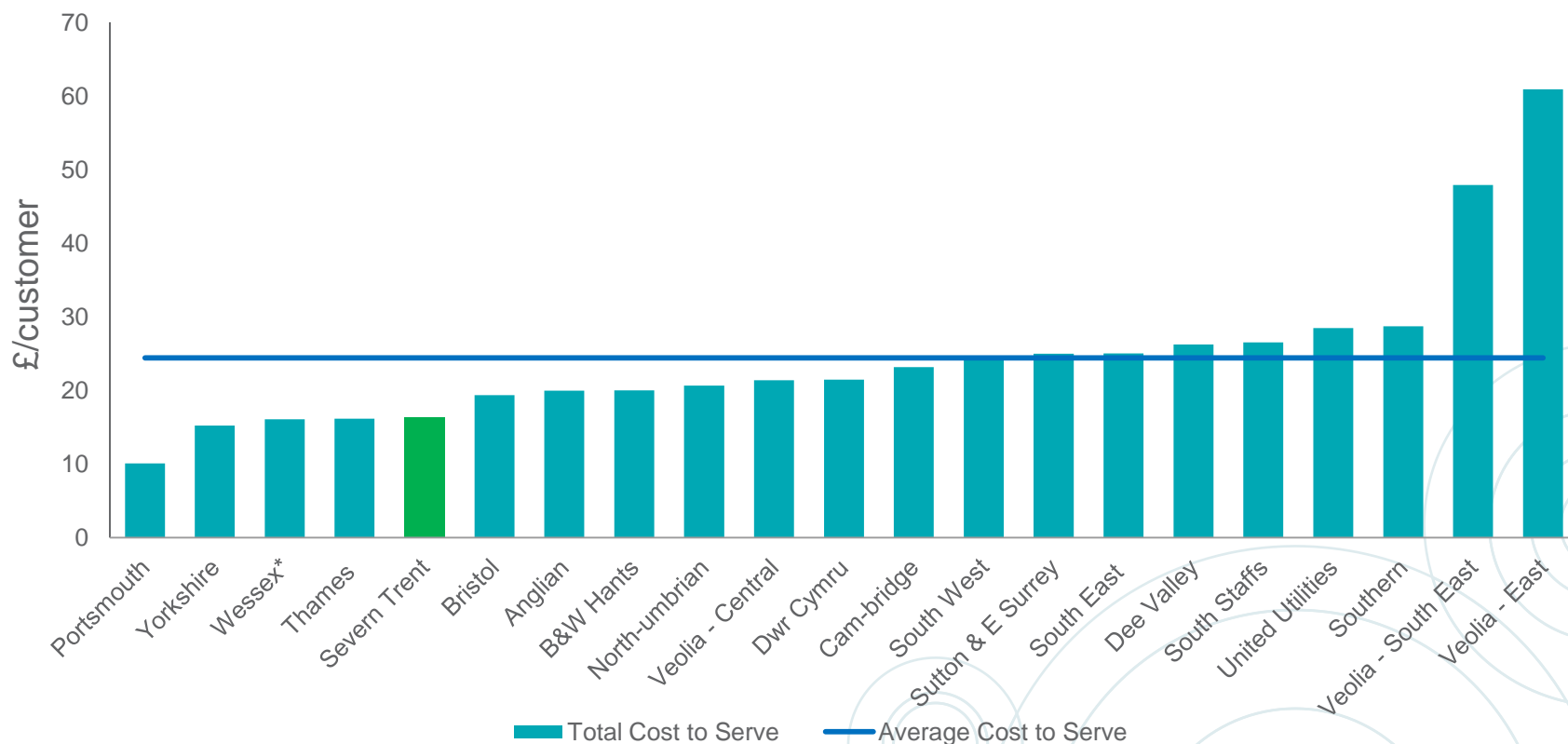
A Wholesale / Retail split

① Framework ② SVT Progress ③ Conclusion

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Cost to Serve ¹



1. Accounting separation data 2012

* Wessex based on JR11 data

① Framework: What does this mean for PR14?

B Outcomes

① Framework ② SVT Progress ③ Conclusion

Severn Trent probable outcomes

Outcome:

1. We provide water that is good to drink

AMP5 Capex Cost
(12/13 prices):

£0.3Bn



For our customers:

- Your water is good to drink

2. We ensure water is there when you need it

£0.9Bn

3. We take your wastewater safely away

£0.5Bn



- Your service is reliable

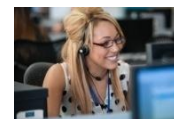
4. We help if you struggle

5. We have the lowest possible charges



- Your bills are affordable

6. We provide excellent customer service



- You find us straightforward to deal with

7. We protect our water environment

£0.7Bn

8. We protect our wider environment

£0.2Bn

9. We respect our communities



- You can trust we are a responsible company

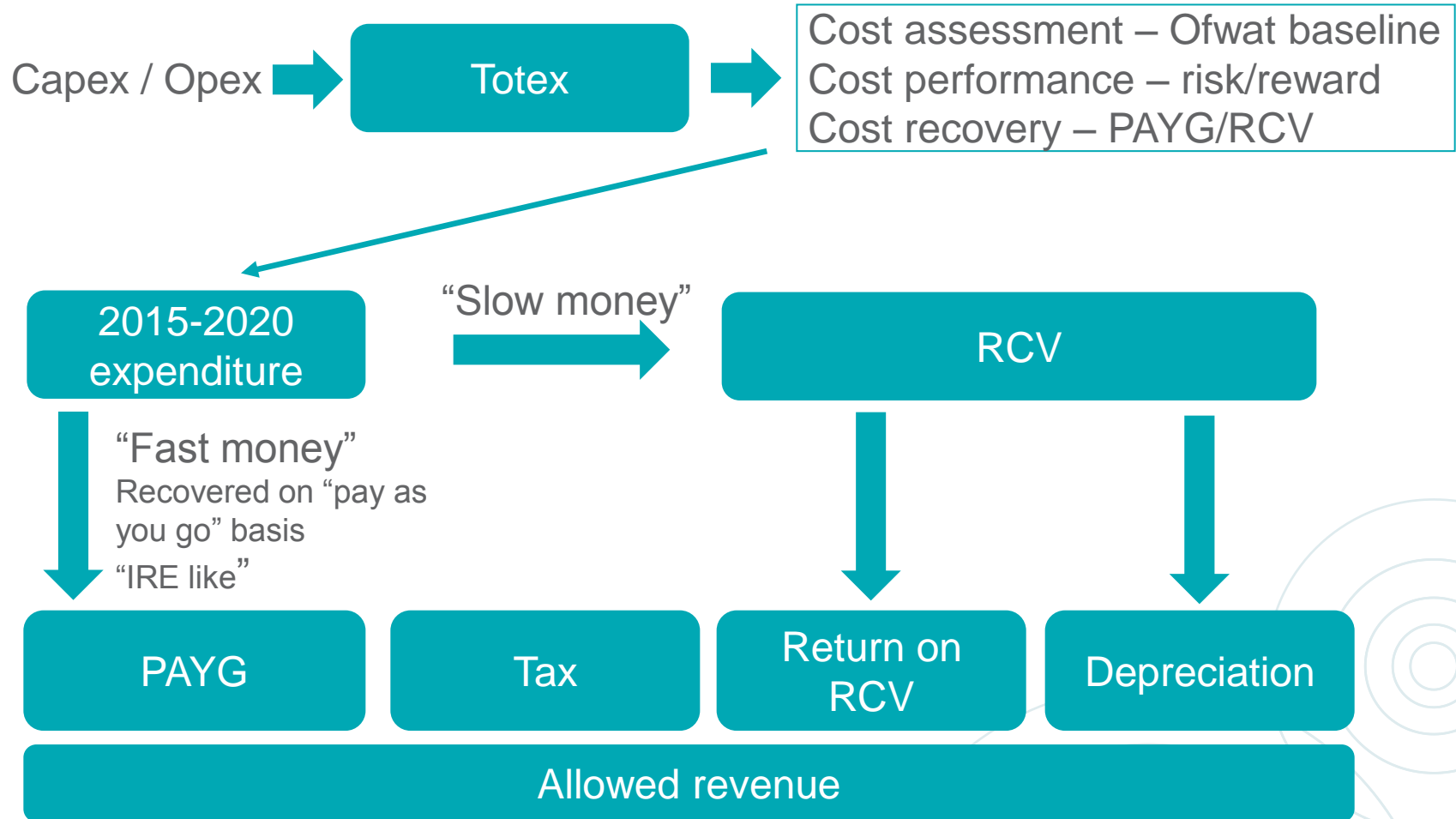
10. We finance our business sustainably

£2.6Bn

① Framework: What does this mean for PR14?

C Incentives

① Framework ② SVT Progress ③ Conclusion



The devil is in the detail: Ofwat publication due summer 2013

① Framework: What does this mean for PR14?

D Stakeholder engagement



PR09 Process



PR14 Process



Customer Challenge Panel – a significant difference from PR09

① Framework: What does this mean for PR14?

D Stakeholder engagement

① Framework ② SVT Progress ③ Conclusion

Greater focus on customer and stakeholder engagement

Customer



Richard Butler
Regional Director,
CBI. Deputy Chair



David Wurr
CC Water



Charley Gibbons
Coventry Citizens
Advice Bureau



Sarah Faulkner
National Farmers Union



Tony Keeling
SSE



Milo Purcell
Drinking Water
Inspectorate



Dame Yve Buckland
Independent Chair

Local authority



Tom McDonald
West Midland Councils

Environment



Adam Lines
Environment Agency

Bruce Laughton
East Midlands Councils



Ian Butterfield
Natural England



Structure for this presentation



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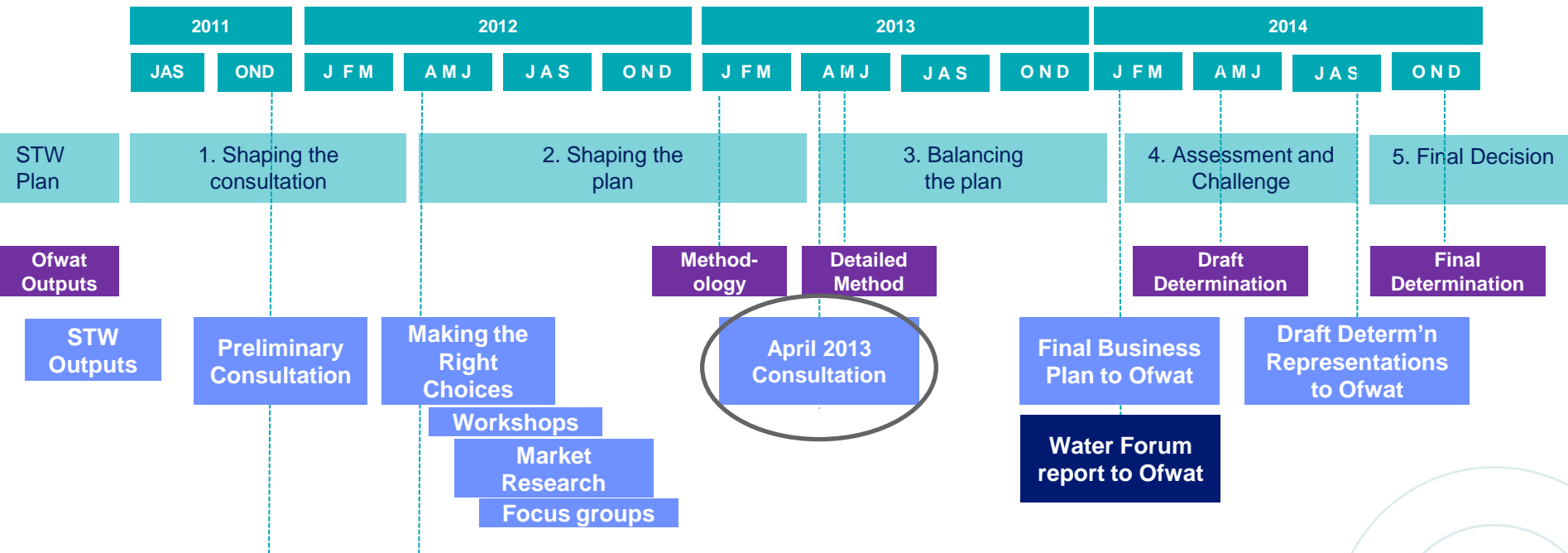
Affordability*

*To be covered in a future presentation

② SVT PR14 progress: Engagement

We have undertaken two rounds of engagement, with a third to go

① Framework → ② SVT Progress → ③ Conclusion



② SVT progress: Engagement

What are we learning?

① Framework ② SVT Progress ③ Conclusion



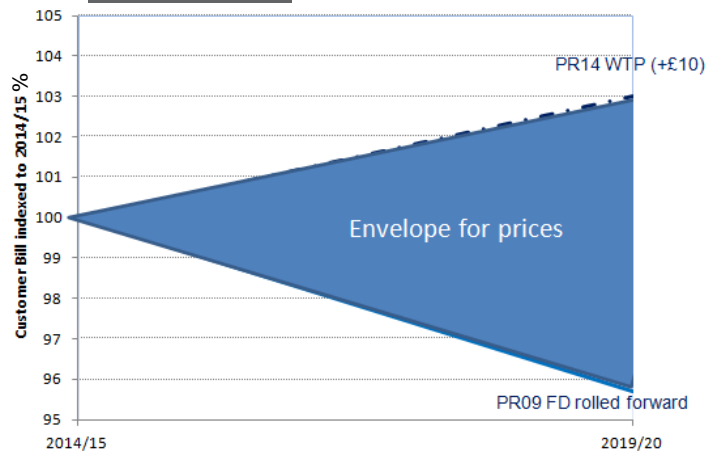
Over 100 stakeholders took part in Making the Right Choices:

- More progressive solutions e.g. catchment management
- Prudent investment now in resilience
- Visible leakage is still an issue
- Do our part with environmental improvements e.g. Water Framework Directive

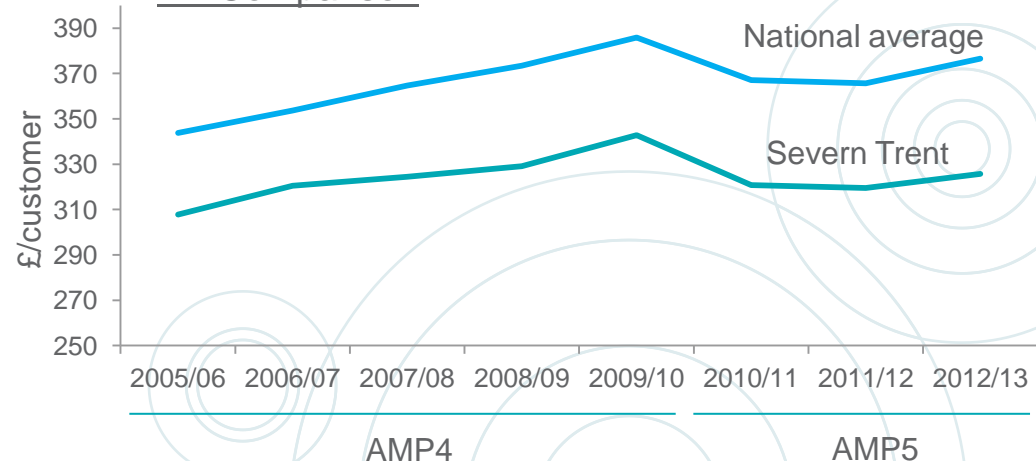
Affordability: Our customer research & engagement suggests:

- Limited appetite for bill increases (average +£10, but many want no increase)
- Stakeholders are concerned about the impact of Welfare Reform on ability to pay

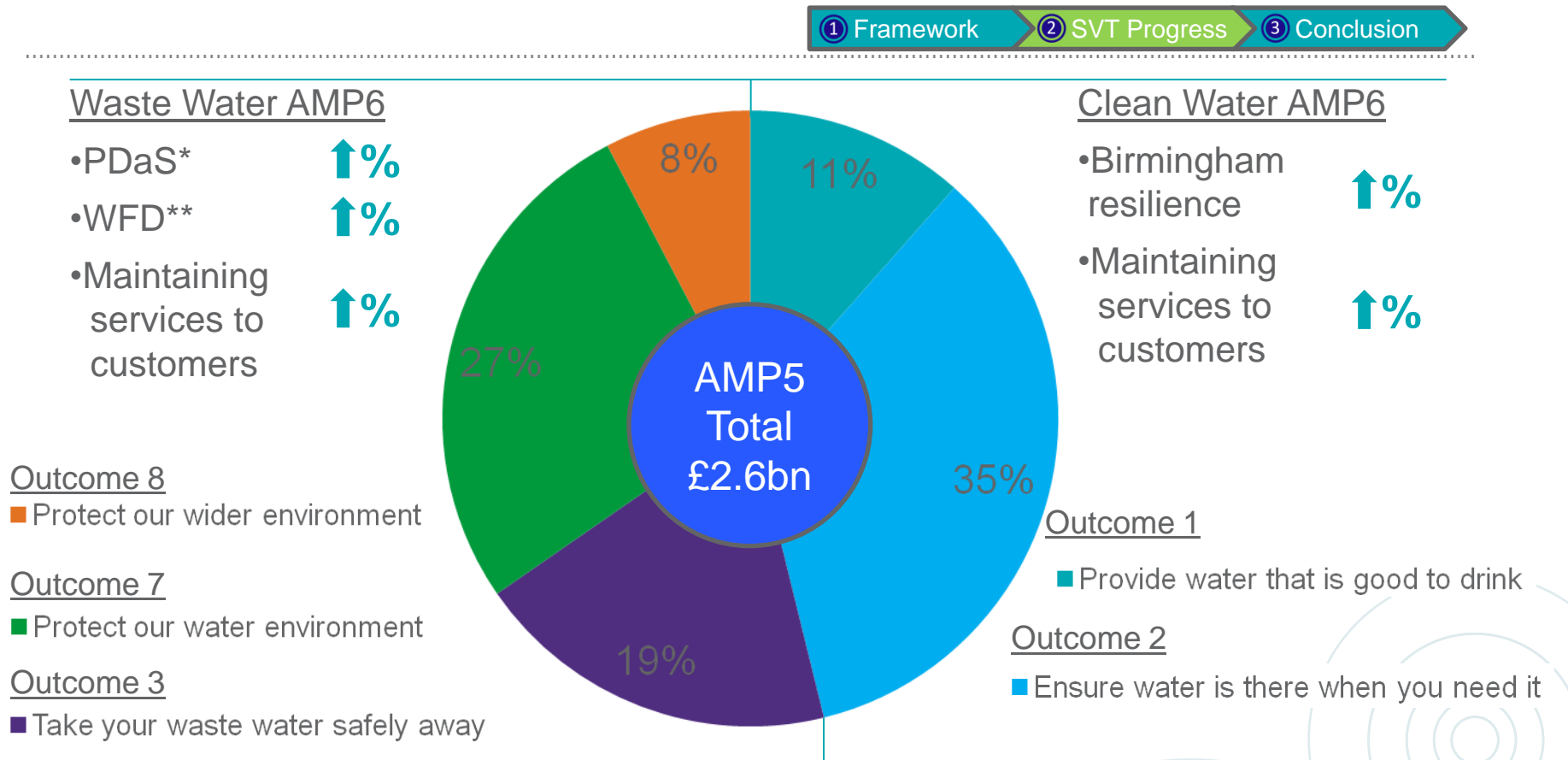
Bill Increase



Bill Comparison



② SVT progress: AMP6 vs. AMP5 capital programme



AMP6 no smaller than AMP5

* PDaS = Private Drains and Sewers

** WFD = Water Framework Directive

② SVT progress: Next steps

Our April 2013 consultation will provide real detail around finding the right balance

① Framework ② SVT Progress ③ Conclusion

- Not a Draft Business Plan for Ofwat
- Promote discussion by outlining options against our outcomes in order to establish investment priorities
- It will explain:
 - How our engagement has led to our proposed outcomes.
 - Our draft long term strategy for these outcomes and the range of choices available for 2015-20.
- We will be using cost estimates and planning assumptions to determine indicative price impacts.
- We will use the consultation to establish priorities and trade-offs, which will help inform the balance for our PR14 Final Business Plan.

Structure for this presentation



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③ Conclusion: Retail – we're supportive of Ofwat's proposals for retail competition, but the devil is in the detail

① Framework → ② SVT Progress → ③ Conclusion

Our initial view

Retail definition

- Scope of what is in/not in the detail
- Agree that metering should stay with the wholesaler
- Making network calls part of retail creates some complexity for competitive market, but should be solvable

Average cost to serve

- Calculation method disadvantages WaSCs vs. WoCs or those companies with high charges
- Calculation unrealistically assumes that bad debt is the same whether a single or dual service is applied
- Creates a strong incentive to keep bad debt down
- Adjust for metering penetration

Retail margin

- Keep non-household default tariffs simple and consistent across UK
- Profitability of a non-household customer of a set size should be equal irrespective of wholesale charge
- Set at a level that allows for a reasonable return for equally efficient new entrants

And for Government/Defra:

Separation

- Option to completely separate business retail function supported by EFRA committee, incumbents, regulators and new entrants
- Consolidate to gain scale economies and make market work

③ Conclusion: Wholesale – we're supportive of Ofwat's proposals for wholesale



- 100% RCV allocated to wholesale
 - 88% of revenues
- Return allowed on RCV
 - Level of return is key => WACC
- RCV and revenues indexed to RPI
- RPI+K limit applied to revenues, not charges
 - Yearly adjustments
- Outcomes & incentives package in line with our proposals (SVT changing course and outcomes/incentives publications – see Appendix)
 - Totex
 - Water trading/ AIM

③ Conclusion: WACC

Longer term view

① Framework → ② SVT Progress → ③ Conclusion



[Web Link](#)

Longer term: The industry still needs more capital

- £100bn of investment since privatisation
 - But environment, climate change and other demands still require significant investment in the future
- Investors will continue to provide this if confidence is maintained
- UK must remain competitive to attract global funds in changing markets
- Need for long term equity
- Highly geared structures transfer risk to customers
- Consequence of failure will affect customers but other companies too

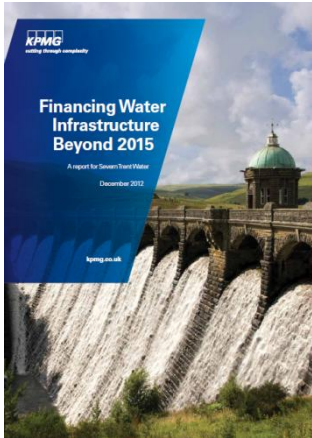
The financial crisis has changed the macro environment

- Risks that were thought unlikely have come about
- The response in the financial services sector
 - Higher capital ratios for banks, limiting their capacity to lend
 - Stronger focus on risks
- The sources of finance available will be more limited and/or more expensive; liquidity cannot be assured

③ Conclusion: WACC

Shorter term view - PR14

① Framework → ② SVT Progress → ③ Conclusion



[Web Link](#)

Short term WACC for PR14: Managing risk should be at the heart of business plans

- Companies should be clear about financial plans and risks – the options for mitigation and financeability requirements
- They should demonstrate that their business and financial plans are robust to downside scenarios
- Are customers comfortable with the risks that they are expected to bear?

Moving away from a “one-size fits all approach” to financing

- With current market conditions CAPM could produce an unsustainable answer – other models should be used to cross check and justify the cost of equity and debt
- It is possible to differentiate the cost of capital based on company risk – as shown in Ofgem’s RIIO and other sectors
- Financeability tests need to be meaningful - there should be a transparent hierarchy of solutions to address problems

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Q & A



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www.severntrentservices.com

Useful Links

**Ofwat
www.ofwat.gov.uk**

**Defra – Department for Environment, Food and
Rural Affairs
www.defra.gov.uk**

**Environment Agency
www.environment-agency.gov.uk**

Appendix

A decorative graphic consisting of several sets of concentric circles in a light blue color. The circles are of varying sizes and are positioned in the lower right quadrant of the page, creating a subtle, abstract pattern.

Appendix - Publications



Regulatory compliance – a proportionate and targeted approach: A consultation
Publisher: Ofwat
[Web Hyperlink](#)



Future price limits – a consultation on the framework
Publisher: Ofwat
[Web Hyperlink](#)



Consultation on wholesale incentives for the 2014 price review
Publisher: Ofwat
[Web Hyperlink](#)



Consultation on retail controls for the 2014 price review
Publisher: Ofwat
[Web Hyperlink](#)



Consultation on Ofwat's section 13 proposals to modify company licences
Publisher: Ofwat
[Web Hyperlink](#)



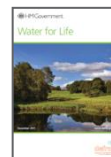
Involving customers in price setting – Ofwat's customer engagement policy statement
Publisher: Ofwat
[Web Hyperlink](#)



Setting price controls for 2015-20 – framework and approach: A consultation
Publisher: Ofwat
[Web Hyperlink](#)



Draft Water Bill
Publisher: Government
[Web Hyperlink](#)



Water for Life
Publisher: Government/Defra
[Web Hyperlink](#)



Changing Course – Delivering a sustainable future for the water industry in England and Wales
Publisher: Severn Trent
[Web Hyperlink](#)



Changing Course – Through water trading
Publisher: Severn Trent
[Web Hyperlink](#)



Changing Course – Through sustainable financing
Publisher: Severn Trent
[Web Hyperlink](#)



Designing incentive packages
Publisher: Severn Trent
[Web Hyperlink](#)



Financing water infrastructure beyond 2015
Publisher: Severn Trent
[Web Hyperlink](#)

Appendix – Customer Challenge Panel



The Confederation of British Industry

<http://www.cbi.org.uk/>



Consumer Council for Water

<http://www.ccwater.org.uk/>



Citizens Advice Bureau

<http://www.citizensadvice.org.uk/>



National Farmers Union

<http://www.nfuonline.com/>



Scottish and Southern Energy

<http://www.sse.co.uk/>



Drinking Water Inspectorate

<http://dwi.defra.gov.uk/>



West Midlands Councils

<http://www.wmcouncils.org.uk/>



Environment Agency

<http://www.environment-agency.gov.uk/>



East Midlands Councils

<http://www.emcouncils.gov.uk/Home>



Natural England

<http://www.naturalengland.org.uk/>

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