Affordability and financeability

Annex 04

Severn Trent
29 January 2021

WONDERFUL ON TAP

Contents

1. Summary

Our green recovery proposals would deliver substantial additional investment in a financially sustainable and affordable way. We have developed our funding proposals in line with the sustainable framework for financing that underpinned our PR19 plan, and with a particular emphasis on tackling affordability challenges in the short, medium and longer-term.

We plan to fund our green recovery investments [redacted]. This will allow us to rapidly ramp up our proposed investment, while spreading the impact of this on bills over many years to reflect the long-run nature of expected benefits. The tough conditions that some households are facing, and are likely to continue to face over the next few years, makes limiting AMP7 bill impacts a particular priority. Our proposals reflect this by applying a pay-as-you-go (PAYG) rate (15%) that is lower than the historical level, the level applied at PR19, and the estimated natural rate for this investment, and deferring all RCV run-off until AMP8. Our approach will provide for £731m of additional green recovery investment in AMP7 with customer bills going up in the remainder of AMP7 by only £6 on average – a level of increase that more than 70% of our customers support. Our proposal profiles our revenues such that there is no impact on bills until 2023-24. This means the bill impact is zero in 2021-22, zero in 2022-23, £9 in 2023-24 and £15 in 2024-25. This profile allows for a modest overall reduction in bills in real terms by the end of the AMP from the current 2021-22 level.

A modest increase in funding from customer bills late in AMP7 would be needed to enable our green recovery investments to be provided in a financially resilient way, and in particular to maintain our BBB+/Baa1 credit rating (when assessed on both a notional and actual company basis). As well as supporting a sustainable approach to financing, our proposed funding arrangements provide for an expected bill profile that is more stable than would result from deferring all cost recovery until AMP8.

Alongside this approach to limiting AMP7 bill impacts, we have a well-designed range of mechanisms currently in place that we will use to support our customers who are struggling and/or just about managing. We have also been ramping up support for our communities in this difficult period, for example, through our emergency fund for local frontline charities. Our proposals help to tackle medium and longer-term affordability challenges through: the economic stimulus and job opportunities that would be provided to the Midlands economy; the targeting of our investment and associated benefits on relatively deprived areas; and the productivity improvements we expect to identify that will help meet ongoing and future resilience and sustainability challenges in more affordable ways.

This Annex provides further details on the above points.

2. Our approach to developing a financially sustainable and affordable funding mechanism

2.1 Providing for a fair balance of charges over time

Our approach to funding our green recovery proposals has been developed in line with the sustainable framework for financing that underpinned our PR19 plan. A central part of that framework was our approach to the balance of charges over time, which was guided by three core principles that were strongly supported by our customers during our PR19 deliberative research:

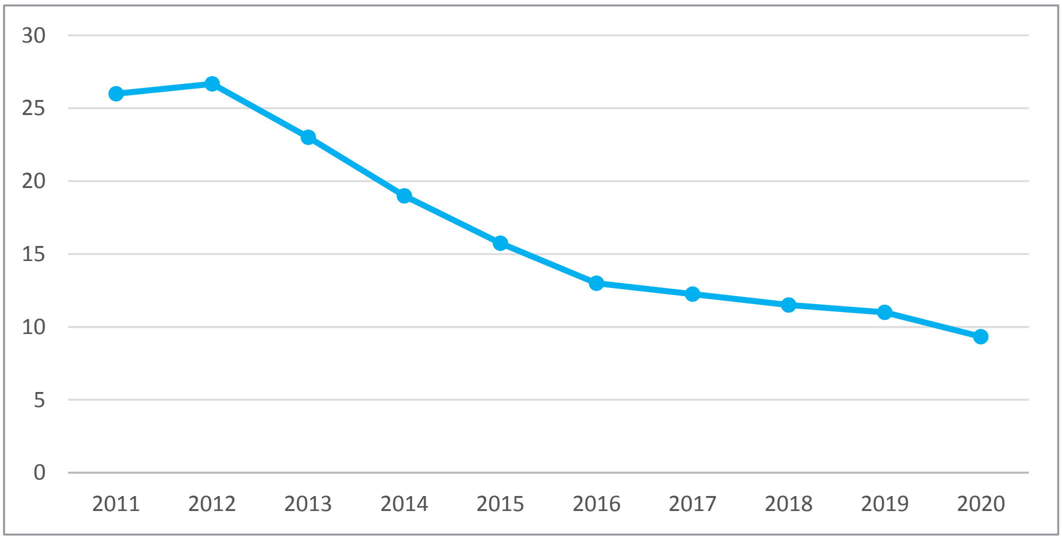
- **Each generation of customers should pay their fair share**: the costs of investments that will deliver benefits over many years should be spread over time to provide a fair balance of charging.
- **Bills should be stable over time, where possible, avoiding big fluctuations up or down**: where possible, we should aim to ensure that prices are changed in ways that are sustainable so that undue bill volatility is avoided.
- **The balance of charges over time should enable us to maintain a stable, low cost platform for investment**: our target credit rating of BBB+/Baa1 is central to our sustainable approach to financing, and underpins our ability to continue to deliver substantial investments to improve outcomes for customers and the environment while keeping bills low.

In applying these principles, we have given particular attention to, and sought to better understand, affordability pressures and customer views on the acceptability of bill increases in the context of the pandemic.

2.2 Affordability pressures and the pandemic

Our customer evidence has not yet indicated a material Covid effect on customer affordability concerns. As Figure 2.2.1 below shows, the percentage of customers finding our bill unaffordable reduced considerably during AMP5, and has continued to reduce more slowly through AMP6. This downward trend has continued so far in AMP7, notwithstanding the pandemic, with the proportion of our customers finding their bills unaffordable having fallen to just under 10%.

Figure 2.2.1: Percent of Severn Trent customers finding their bill unaffordable



Our on-going tracking suggests that COVID-19 has created anxiety for around 20% of our customers about their ability to pay in the future, but at the current time this is not manifesting in changes in payment habits which – using a range of lenses – are continuing to broadly track 2019 patterns. For example, as shown in Figure 2.2.2, payment cancellations have continued at levels very similar to 2019 for customers identified as good and bad payers (based on credit rating agency scores).

Figure 2.2.2: Number of Severn Trent customers cancelling their payment plans for previously good payers and bad payers

[Redacted]

Customer payments in 2020 were around 4% higher relative to pre-Covid levels, and the number of customers slipping into arrears was about the same as in 2019. The number of our payment collection suspensions was also relatively flat since the first lockdown for both 'good' and 'bad' payers (see Figure 2.2.3), and we believe our level of payment collection suspensions has been significantly lower than that of most other water companies, based on Water UK payment data.[1] We would expect our relatively low bills, and the effectiveness of our affordability schemes, to have contributed to this.

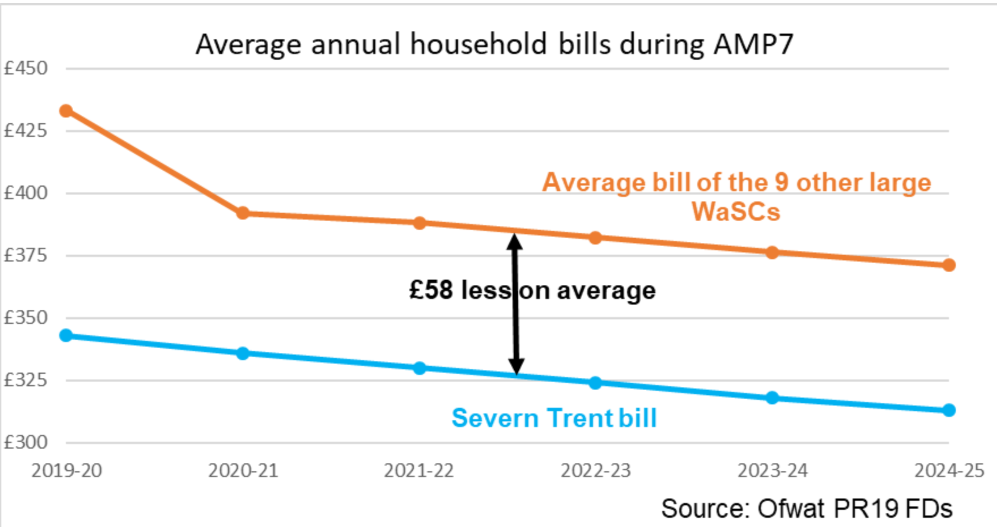
[1] Water UK publishes anonymised payment data for 17 water companies. We believe that this shows our level of payment collection suspensions to be among the lowest.

Figure 2.2.3: Number of Severn Trent payment collection suspensions for previously good payers and bad payers

[Redacted]

Our annual average combined service household bill is currently one of the lowest of the ten large water and sewerage companies (WaSCs), and is due to be the lowest in 2023-24 and 2024-25, based on the figures in Ofwat's PR19 final determination. Our average household bill is expected to be £58 per year lower than the average across the other nine large WaSCs for AMP7, and that difference will be even greater if the CMA's final determination results in the four appellant companies being allowed to raise their bills in 2022-23 to 2024-25.

Figure 2.4.1: Severn Trent's average annual household bill and the average of the other nine large WaSCs



One broader reason for the relatively limited evidence of affordability challenges in payment patterns is that household budget reviews during the pandemic appear to have been focused primarily on discretionary spending. Also, reductions in spending have exceeded reductions in income on average, with these trends underpinning the substantial increase in household savings since the start of the pandemic, that the Bank of England has highlighted.[2]

Notwithstanding these positive signs, the pandemic raises particular concerns over affordability pressures within AMP7 and beyond, given the tough conditions that some households are facing, and/or are likely to face over the next few years. Given this, we have put in some immediate additional, targeted support for customers who are struggling with bills, and have placed a high priority on limiting the overall bill impacts of our proposed green recovery investments, based on the careful consideration of our customers' views on the acceptability of bill increases to fund our green recovery plans (summarised below). Our green recovery proposals are designed to help improve employment conditions in the coming months by creating over 1,550 jobs directly and a further 1,450 in the supply chain.

2.3 Our support for customers and communities

Limiting overall bill increases provides an important means of managing the affordability pressures associated with our plans. However, tackling affordability challenges in a range of more targeted ways is also central to our proposals. This includes:

- **Providing financial support for customers who are struggling and/or just about managing**: We have a well-designed range of mechanisms in place that we will use to provide support for our customers who are struggling financially and/or just about managing. This includes our Big Difference Scheme social tariff that we are reforming so that it covers more customers and is better targeted at those most in need. We also donate £3.5m to the Severn Trent Trust Fund every year so that it can help those in severe hardship.
- **Supporting our communities**: We have ramped up the support we provide to our local communities in this difficult period. We brought forward £39m in early payments to support our suppliers, and gave out £1m of emergency funds to help local charities and groups on the frontline of tackling the effects of the pandemic. We didn't furlough our teams, but focussed on delivering improved services for our customers. Following our new commitment in our PR19 business plan we are donating 1% of our profits (around £2.5m per year) to community projects.
- **Targeting our green recovery proposals on relatively deprived areas**: Our proposed investments are targeted on relatively deprived areas, and thus on providing additional benefits and/or support to areas in which affordability issues are likely to be greater. Our proposals would create additional amenity benefits and help to address 'insurance premium poverty' (as can be experienced by those susceptible to flooding or less able to pay for supply pipe repair/insurance) in those areas.
- **Providing a much needed economic stimulus to the Midlands economy**: Our proposed green recovery investments would provide an important stimulus to the Midlands economy, creating over 3,000 jobs directly and through our supply chain, and also creating jobs indirectly through the (multiplier) effect on local incomes and spending. We are directly creating jobs through training plumbers, and supporting apprenticeships, and are supporting 500 16-24 year olds with

[2] Bank of England (November 2020), How has Covid affected household savings?

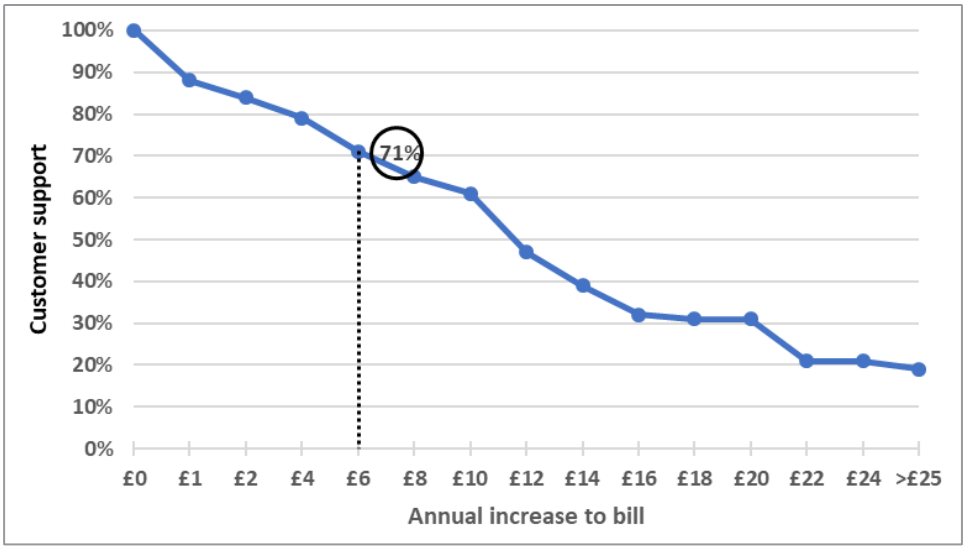
paid work experience through the Kickstart Scheme. By focusing on innovative areas of environmental improvement, the stimulus this provides can be expected to have an enduring impact.

The innovative and exploratory nature of our proposals is also important for affordability in the longer term. Meeting the resilience and sustainability challenges we face has the potential to put substantial upward pressure on future generations' bills, if continued reliance is put on traditional models for delivering improvements. We are targeting a step change in productivity and the pursuit of natural solutions, which will be critical to us delivering our service in a fair and affordable way in the future. Our proposals reflect this.

2.4 Customer views on the bill impacts of our proposals

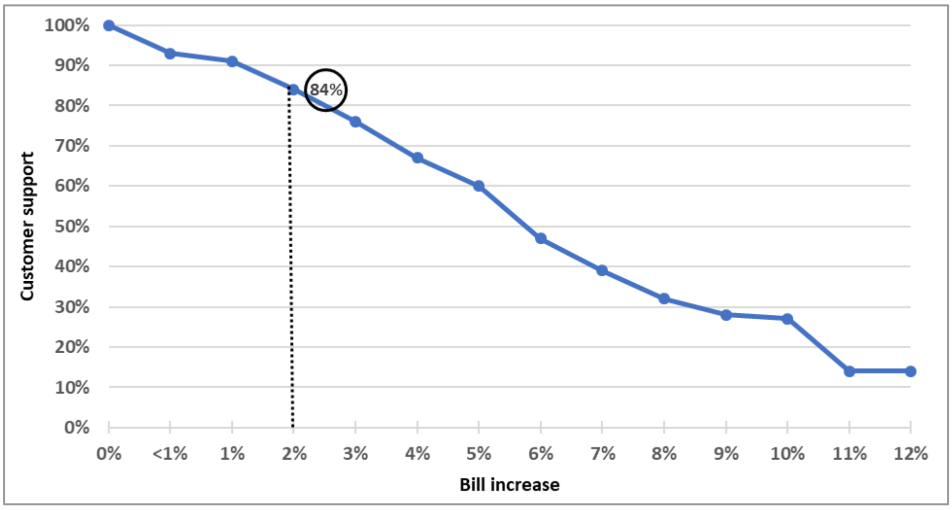
There is strong support from our customers for our green recovery proposals, with independent research showing that more than seven in ten of our customers (71%) are willing to pay £6 or more on their annual average bill for our four main green recovery projects (with around two thirds willing to pay £8 or more). Customer support for an £6 bill increase is fairly evenly spread across customer groups by age, socioeconomic group, metered or unmetered and size of annual bill, with support above 65% in every group. Customer support for a £6 bill increase is above 50% among those who struggle to pay their water bill or worry about not being able to afford their water bills. The lower level of support among this group emphasises the importance of our financial support schemes for customers that face affordability issues.

Figure 2.4.1: 71% of households support a £6 bill increase for our green recovery projects



Non-household customers support our proposals even more strongly than household customers: 84% of non-households support a 2% bill increase for the green recovery projects and our proposals would increase their bills by around 1.8% on average. Support for a 2% bill increase is higher, at 92%, for those non-household customers who have experienced a positive financial impact from Covid-19; is 85% for those who have seen no financial impact; and is 79% for non-households where Covid-19 has had a negative financial impact on their business.

Figure 2.4.2: 84% of non-households support a 2% bill increase for our green recovery projects



The household and non-household willingness to pay numbers shown above relate to only 77% of our proposed investment (£564m), as our research did not include the £168m of proposed WINEP acceleration. This means that the figures on the acceptability of bill increases shown above are likely to underestimate willingness to pay for our overall green recovery proposals, as our customers would be getting more for their money than we asked them about.

Our willingness to pay research focused on customers' views on (the main parts of) our green recovery proposals as a package, rather than on each of our business cases individually. Typically, we and other companies have found that the willingness to pay for packages of projects is lower than the willingness to pay for individual projects aggregated together. We therefore consider we have taken a conservative approach to testing our customers' willingness to pay for our green recovery business cases.

3. [redacted]

4. Our proposal limits AMP7 bill impacts

4.1 Reducing the bill impact

In line with the guidance on the regulatory assessment process for green recovery proposals, we have considered different levers that can be used to reduce the impact our green recovery investments would have on AMP7 bills. Our proposed approach is to significantly reduce the impact on AMP7 bill impacts by:

- **Applying a PAYG rate of 15%**: this is much lower than the rate used at PR19 – which was in line with our historic rate (around 60%), and is lower than the estimated natural rate of our green recovery proposals (around 17%).
- **Applying an RCV run-off rate of 0% during AMP7**: this results in £37m of RCV run-off being deferred.

In addition to this, we have profiled revenue recovery over the remainder of AMP7 to avoid any impact on bills arising until 2023-24. The revenues that we would need to recover from customers during AMP7 to support our proposed green recovery investments – given the use of these levers – is shown Table 4.1.1 below.

Table 4.1.1: Total wholesale revenue allowance for green recovery investments

£m (2017/18 prices)	AMP7 impact (£m)
PAYG: 100%	834[3]
FD PAYG and Run-off rates	483
Using estimated natural rates for proposal	165
Our proposed approach	105

The first row of the table shows the total expected impact on revenue of using a PAYG rate of 100%, which would imply recovering all AMP7 spend through AMP7 bills. Applying the final determination (FD) PAYG rate would mean that around 40% of our expenditure was funded as 'slow money', but would still result in AMP7 wholesale revenues increasing by £483m because of green recovery investments. Using our estimate of the natural PAYG and RCV run-off rates for our proposed investments would result in a significantly lower increase in AMP7 wholesale revenues (£165m). By applying a PAYG rate of 15%, and deferring all of the AMP7 RCV run-off that would be expected to apply, our proposed approach would further significantly reduce the impact on AMP7 revenues (and thus bills). In particular, our approach would involve AMP7 wholesale revenues increasing by £105m, in order to support substantial additional green recovery investment in AMP7, and our approach to profiling would mean no impact on revenues or bills until 2023-24.

Our view is that this represents the most appropriate approach to funding, given the principles (concerned with the balance of charges over time), affordability pressures, and bill acceptability research identified above. In particular, we consider this approach to:

- provide for a fair balance of charges over time;
- avoid undesirable bill volatility;

[3] The AMP7 revenue figure is higher than our proposed green recovery totex primarily because of the impact that a 100% PAYG approach would have on tax allowances.

- provide a stable, low-cost funding platform; and
- allow our green recovery investments to be delivered with a bill impact that has strong support from our customers.

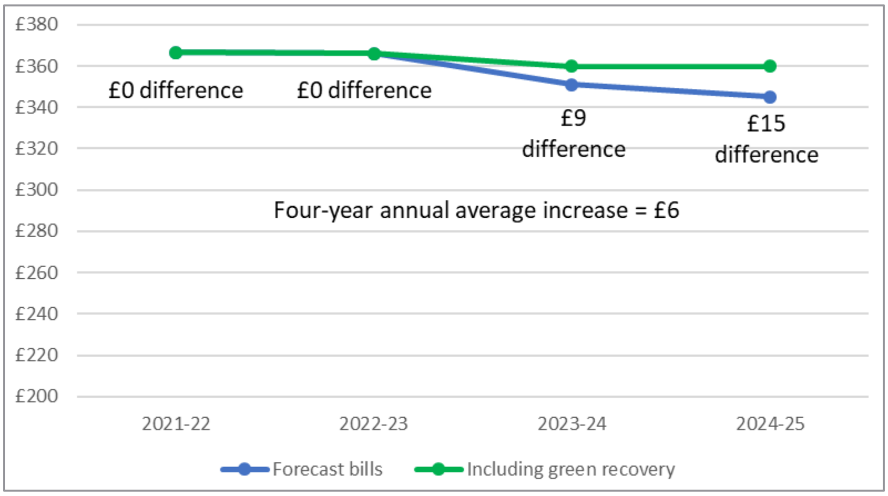
4.2 A fair balance of charges over time

We would typically expect the principle of each generation paying its fair share to be best achieved by setting PAYG and RCV run-off rates at a level that broadly reflects the relevant natural rate (recognising that there are different ways in which it may be appropriate to estimate natural rates). Our approach involves deliberately setting PAYG and RCV run-off rates below estimated natural rate levels given the circumstances our customers may face as a result of the pandemic. However, our customer acceptability research (and the ramping up of the support we provide to customers who may be struggling) has allowed us to guard against an unduly high level of costs being deferred until after AMP7 to be paid for by future generations of customers.

4.3 Avoiding undesirable bill volatility

Our proposed funding approach provides for a more stable expected bill profile than would result from deferring all cost recovery until AMP8. We consider this to be important given the extent to which our research has consistently shown the stability of bills to be a key concern for customers.

Figure 4.3.1: The impact of the green recovery on the average annual household bill in real terms



4.4 Providing a stable, low-cost funding platform

Our proposed green recovery investments would clearly be financeable on a notional company basis if PAYG and RCV run-off rates were set to reflect the relevant natural rates – that is, consistent with the approach to assessing notional financeability applied at PR19.[4] However, as set out above, we have sought to dampen the bill impacts associated with our proposed investments by using the PAYG and RCV run-off rate levers – setting them at below estimated natural rate levels.

We consider our proposed approach – with a PAYG rate of 15%, and RCV run-off rate of 0% for AMP7, and revenues profiled to avoid any bill impact until 2023-24 – to provide a stable platform for rapidly

[4] We have not shown the estimated credit metrics under this scenario, but the results for our proposed approach (with lower PAYG and RCV run-off rates) show that this holds.

delivering on our green recovery proposals. Our expected credit metric performance, on a notional company basis, is shown in Table 4.4.1 below for our proposed approach.

[redacted]

We consider our proposed approach to strike an appropriate balance between financeability and affordability pressures.

Table 4.4.1: [Redacted]

[redacted]

We considered whether it might be appropriate to apply an approach that deferred even more AMP7 spend, for example, by applying a PAYG rate that was lower than 15%, where that could be shown to be financeable on a notional company basis. [Redacted}

Table 4.4.2: Redacted

[Redacted]

4.5 Adjusting our in-AMP RCV to show our effective gearing

We are proposing that the RCV adjustment for the green recovery projects will be added to our RCV in the midnight adjustment at the start of AMP8. This helps us to deliver the investment to boost the local economy and jobs while keeping bills down for customers during the recovery from the Covid-19 pandemic. To avoid us being disadvantaged in our gearing metric by taking this approach we ask that Ofwat includes the slow money element of our green recovery expenditure in our "in-AMP" RCV, which shows our effective RCV in anticipation of the actual RCV midnight adjustment at the beginning of AMP8. This will give a fairer measure of our effective gearing.

4.6 A £6 average AMP7 bill impact that is supported by more than 70% of our customers

Table 4.6.1 below shows our forecast bill profile before any consideration is given to green recovery spend. Our forecast bills are shown in 2020-21 prices, and include the known effects of RFI adjustments and the £50m (gross) of estimated net ODIs for 2020-21 that we announced in our trading update on 1 February 2021. When our green recovery proposals are included, our bill forecast continues to show a modest real terms reduction over the rest of the AMP, with bills around £7 lower than the 2021-22 level at the end of AMP7.[5]

Table 4.6.1: The impact of our green recovery proposals on annual average household bills

(£, 2020-21 prices)	2021-22	2022-23	2023-24	2024-25	Average bill impact: 2021/22 – 2024/25
Forecast bills	£367	£366	£351	£345	
Including Green Recovery	£367	£366	£360	£360	
Change in bill	£0	£0	£9	£15	£6
					Total AMP7:
Forecast spend under our green recovery proposals (£m, 2017-18 prices)	£80m	£136m	£254m	£262m	£731m

Notes: the forecast bills include known revenue forecasting incentive (RFI) adjustments and the £25m of estimated ODIs for 2020-21 that we announced in our interim results in November 2020, that are recoverable in 2022-23.

As can be seen, our proposed funding approach results in bills being on average £6 higher than otherwise expected between 2021-22 and 2024-25. Our proposed approach, therefore, allows for £731m of green recovery investment to be rapidly mobilised, with an average AMP7 bill impact of only

[5] We note that our expected 2021-22 bill is £8 higher than our 2020-21 bill in order to address Covid issues, and we understand other companies to be introducing similar increases.

£6 – a level that was supported by more than 70% of our customers. Our proposal profiles AMP7 revenues to avoid any impact on bills arising until 2023-24, and still allows for a modest overall reduction in bills in real terms by the end of the AMP from the current 2021-22 level.

As was set out above, our proposals seek to tackle the range of affordability challenges our customers face in a balanced way, but with a particular focus on vulnerable customers and communities, while maintaining a stable platform for low-cost financing.

4.7 Long-term affordability

Our green recovery projects, if they go ahead, will reveal new information on more efficient ways to, for example, remove lead supply pipes, install smart meters and put in place sustainable drainage systems. This information will allow companies and Ofwat to better identify the most cost-effective ways to address these long-term challenges and help to limit pressures on customers' bills. To maximise these benefits our green recovery proposal includes commitments to sharing information with other water companies and third parties.