PR24 Redetermination

Statement of Case

21 March 2025

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

Contents

1 Executive summary 3
2 Our story 13
3 Our PR24 plan for resilience 27
4 Costs 33
5 Outcomes 66
6 Risk and return 77
7 Financeability and investability 85

Annexes (see separate documents)

Annex A – Glossary

Annex B – Legal and regulatory framework

Annex C – Initial observations on Ofwat materials

Annex D – Supporting information

Annex E – Growth and resilience

Annex F – Outcomes and Water Supply Interruptions

Annex G – Enhancement costs

Annex H – Risk and financeability

Annex I – PR19 reconciliation: NHH Voids

Annex J – Sources post-dating PR24 FD

Expert reports

ChandlerKBS, “Industry Cost Modelling Methodology & Service Reservoirs”

Economic Insight, “Frontier shift at the PR24 Redeterminations”

KPMG, “Estimating the Cost of Capital for PR24”

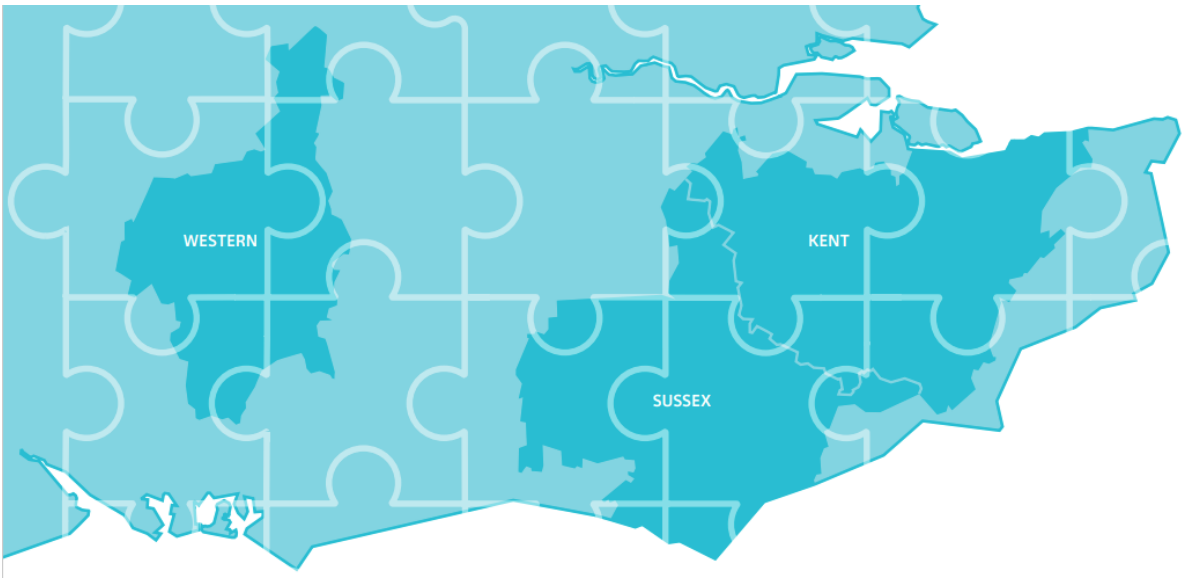
KPMG, “PR24 Cost of Debt: Analysis of the Infrequent Issuer Premium”

KPMG, “PR24 Final Determinations – Risk Analysis for a Notional Company”

Oxera, “Wholesale base expenditure modelling”

Oxera, “Base cost adjustments and cost adjustment claims”

1 Executive summary



1.1 South East Water Limited (**SEW**) is a small company supplying water only (not wastewater services) to 2.3 million customers in three distinct regions – Kent, Sussex and Western – in the south east of England.

1.2 We have unique characteristics as a result of our history and geography. We have more than 250 small sources supplying local areas and many licence-restricted ground-water sources which require significant treatment and/or are subject to raw water quality variability. We operate in an area of severe water stress with pressure on water resources and in the most exposed region to supply-demand imbalances in England.[1] A key issue is our network interconnectivity and water supply system headroom in our Kent and Sussex regions, leading to greater exposure to supply interruptions when there are large fluctuations in customer demand.

1.3 The current Asset Management Period (or **AMP**) – which is the seventh planned by the UK water industry running from 2020-2025 (known as **AMP7**) – has proved extremely challenging for SEW operationally due to:

(a) **Climate change:** AMP7 has shown that climate change is already causing significantly more frequent and severe weather events.[2] These include:

(i) prolonged hot periods and heatwaves associated with sudden and significant increases in peak demand and droughts;

(ii) heavy rainfall, flooding and storms which impact water availability or quality and the operation of our Water Treatment Works (**WTW**) (either directly or through disruption to our power supplies); and

(iii) freeze-thaw events characterised by a sudden increase in temperature after sustained periods of sub-zero temperatures which cause widespread leakage outbursts on water mains and customer pipes equivalent to extreme peak demand events.

---

1 Environment Agency, 20 December 2024, A Summary of England's Revised Draft Regional and Water Resources Management Plans.

2 This is acknowledged in Ofwat, 24 February 2025, Ofwat's Fourth Climate Adaptation Report, page 6, which states that "*risks from droughts, storms, floods, heatwaves and other extreme weather events are escalating and increasing pressure on water supply … infrastructure, customers, communities and the environment*" and that "*climate change and associated risks are challenging the water sector at unparalleled levels*".

(b) **New usage patterns:** Post Covid-19 changes in consumption patterns with more people working from home within our supply area (a major commuter belt into London) and other lifestyle related changes have resulted in greater peaks in demand, increasing the impact of the frequent extreme weather events we experienced in AMP7 and the stress on our water supply system.

1.4 In addition:

(a) the logic of the Water Resources Management Plan (**WRMP**) process, which assumes that demand reductions compensate for **population growth**, and

(b) the absence of an appropriate regulatory standard or funding allowance for delivering **supply-demand balance headroom**,

combined with

(c) the lack of objective and measurable forward-looking **resilience standards** in the wider regulatory framework that would promote operational headroom,

has meant that there was **no adequate monitoring within the regulatory regime** and that the need for investment to maintain the capacity of the water supply system to absorb unforeseen volatility in customer demand (such as that now being experienced) was not fully recognised.

1.5 We have taken significant action to strengthen resilience in response to high demand events during AMP7 to protect water supply for our customers – even though it meant exceeding our expenditure allowance. We have focused on delivering short-term resilience improvements in Kent and Sussex, where they are most needed. This has included increasing deployable output, laying new pipelines to transfer water between areas and improving asset reliability.

1.6 More specifically, we have reprioritised key schemes within our PR19 investment programme to focus on improving resilience (representing a total value of £91.38m). In addition, we have introduced 15 new supply resilience schemes into our investment programme and accelerated two schemes from PR24. These 17 schemes represent a total value of £18.95m: seven of them were completed in 2023 or early in 2024 and all others are currently in delivery phase. The total value of reprioritised PR19 investment and new or brought-forward schemes amounts to **£110.33m**. This short term response represents a significant effort in the context of AMP7 and is the main driver for the forecast overspend of £96.3m in AMP7 compared to the PR19 Final Determination (i.e. a forecast totex spend of £1.155bn in AMP7 – 22/23 price base – against a PR19 Final Determination allowance of £1.059bn – 22/23 price base). We have also implemented significant improvements to our operational response to supply events and to the information and support we provide to customers.

1.7 The 2024 price review (**PR24**) – setting the price, investment and service package for the next AMP running from 2025-2030 (**AMP8**) – is an opportunity to reset and ensure that, going forward, we are equipped to meet the evolving needs for growth and the communities and customers we serve.

1.8 With this in mind, we have built our PR24 Business Plan:

(a) with a regional focus on improving operational resilience and localised storage, whilst investing in increased network connectivity to improve system resilience;

(b) using feedback from customers and stakeholders to include a coherent programme of supply-side (enhancement) and demand-side (e.g. leakage, water efficiency, smart networks and smart metering) investment to reduce the likelihood, extent and duration of supply interruptions caused by high demand events in Kent and Sussex in AMP8. This is also the foundation for the next stages of resilience investment in future AMPs under our Long Term Delivery Strategy (**LTDS**); and

(c) supported by an improvement in financial resilience – underpinned by a significant reduction in gearing in addition to equity injected in AMP7 – to ensure we remain agile in the face of the obligations that we must deliver to our customers.

1.9 Overall, our PR24 Business Plan achieved 71% customer acceptance, and our research showed customers specifically supported that range of investment to improve resilience and water security. We engaged constructively with Ofwat both before and throughout the PR24 process to explain the issues that we are facing as a business and our plans for addressing those challenges. However, we were disappointed in July 2024 to receive a Draft Determination (**PR24 DD**) that was wholly mis-calibrated to the circumstances of our business, our customers and our supply area.

1.10 Ofwat made improvements in the PR24 Final Determination dated 19 December 2024 (**PR24 FD**) but, as recently noted by Moody's, it remains "*one of the most challenging determinations in the sector for AMP8*".[3] Having carefully considered the PR24 FD, we remain concerned by its failure to address our company-specific circumstances and external challenges. Coupled with acknowledged gaps in the regulatory framework, Ofwat's PR24 FD leaves SEW precariously positioned – needing everything to 'go right' in AMP8 for us to deliver for our customers. We face a 13% funding gap overall and much larger gaps of 50-60% in key areas for water security, significant penalties for water supply interruptions and a material imbalance in risk and return. Taken together, Ofwat's short-term focused settlement – despite the additional financial resilience we have built in – undermines financeability, investability and our plan for resilience now and in the future.

1.11 More particularly, we consider that Ofwat's PR24 FD is flawed in the following respects:

(a) **Costs**: Ofwat's costs methodology is technically flawed and too generic in its application to individual companies, resulting in unwarranted underfunding of efficient and necessary costs. These issues are further compounded when Price Control Deliverables (**PCD**s) are attached to schemes with insufficient funding. In addition, the conditions to access a ring-fenced £50m resilience contingent allowance that Ofwat provided in the PR24 FD are overly restrictive and do not protect consumer interests.

(b) **Outcomes**: Ofwat's approach to water supply interruptions is unfair, disproportionate and punitive – singling out SEW for a wider penalty collar of -2% RoRE, double that which applies to the rest of the industry and four times the level of many other ODIs – and inexplicably disconnected from the timing of our related resilience investment. It also takes no account of the risks of increased extreme weather due to climate change. This sets SEW up to fail from Day 1 of AMP8.

(c) **Risk and return**: There is a material imbalance in Ofwat's PR24 FD package. Risk is increasing and the allowed return is not fair or commensurate with the returns that equity investors can obtain on comparable investment opportunities elsewhere.

(d) **Financeability and investability**: Overall, the PR24 FD is not financeable or deliverable. The allowed return is objectively too low for equity investors and undermines debt financing and there is insufficient financial headroom to allow SEW to manage risk. This leaves unacceptable water security risks for our customers in the short and longer term, undermining our plan to re-establish headroom, operational flexibility and resilience.

1.12 Each of these flaws presents significant challenges individually, but they also combine to create a precarious position that is unsustainable for SEW and its customers. Specifically:

(a) The remaining gaps in resilience enhancement and in key elements of base expenditure will impact SEW's ability to mitigate the risks of supply interruptions caused by high demand events or major operational incidents (in a context where, due to growth and climate

[3] Moody's, 4 March 2025, Moody's Ratings maintains negative outlook on South East Water; affirms Baa3 ratings.

change, there is a high likelihood that our customers will continue to experience significant interruption events in AMP8).

(b) This will result in unavoidable and overly punitive penalties for SEW under the water supply interruptions Outcome Delivery Incentive (**ODI**) and invariably further penalties under other ODIs (in addition to the inherent costs of such events or incidents).

(c) This, combined with the loss of flexibility in the allocation of enhancement and base expenditure resulting from PCDs and a rigid ODI regime, will severely restrict SEW's capacity to address likely and plausible risks by prioritising and reallocating expenditure and resources. As a result, our investments risk being reactive, less efficient, and not best suited to delivering consistently with customers' longer term interests.

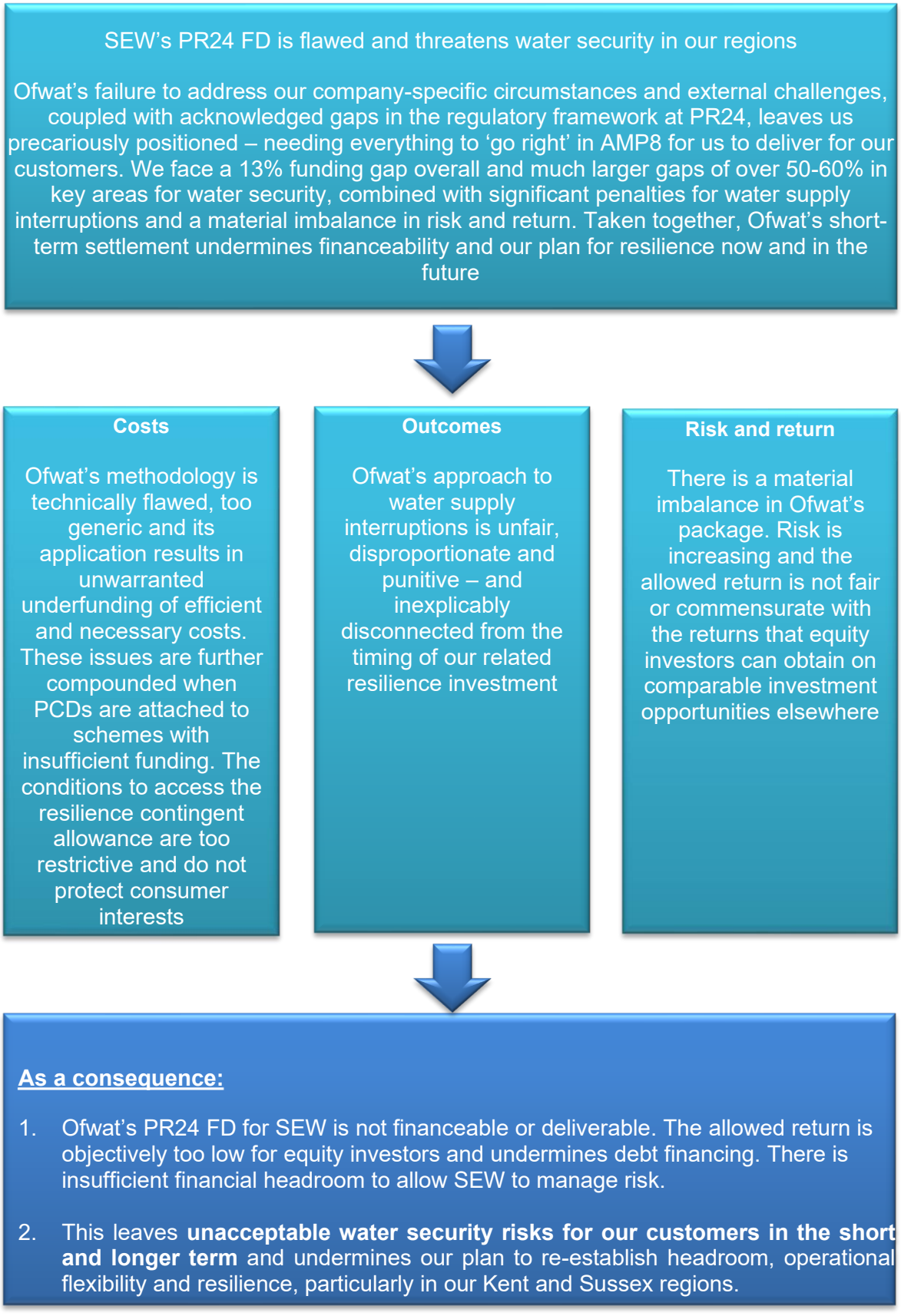
(d) It is also likely to impede investment in our water supply system at a suitable level, even if we overspend our allowed expenditure.

(e) Further, financeability and investability issues will have a material impact on financial resilience, compromising SEW's ability to face risks and limiting our access to the capital needed to deliver our largest investment programme to date.

(f) We therefore consider that PR24 FD results in an overall level of risk that is unsustainable and that, contrary to Ofwat's statutory duties (including its new growth duty) and the government's strategic priorities and objectives for Ofwat's regulation of the water sector in England, it does not: protect the interests of consumers; secure that our functions are properly carried out and that we are able to finance those functions; or secure the long-term resilience of our water supply system as regards environmental pressures, population growth and changes in consumer behaviour.

1.13 We have captured the above in 'at a glance' form in Figure 1.1 for the CMA's ease of reference.

Figure 1.1: Our PR24 Statement of Case – An 'at a glance' overview



1.14 Section 2 (Our story) of and Annex D (Supporting information) to this Statement of Case provide further detail on the challenges that we face as a business given our unique characteristics.

1.15 The following paragraphs look in more detail at each of Ofwat's constituent building blocks of the PR24 FD.

Costs

1.16 Despite the increase in allowed expenditure in the PR24 FD compared with Ofwat's earlier PR24 DD, there remain significant gaps in key expenditure allowances which will prevent adequate mitigation of our main operational risks and leave unacceptably high risks of supply interruption for our customers in Kent and Sussex.

1.17 More specifically:

(a) Unjustified modelling assumptions, gaps in base capex (mains renewal, metering, smart networks, network reinforcement) and ring-fenced base expenditure associated with PCDs result in an insufficient base allowance (with residual unallocated base allowance less than in AMP7 despite growth in our customer base). This provides significantly less flexibility to maintain our wider asset base (including critical infrastructure) and, in turn, affects our operational resilience and ability to meet customer service levels.

(b) Gaps in key enhancement expenditure on both sides of the supply-demand balance (Bewl WTW, service reservoir upgrades, Smart Network, leakage, water efficiency, resilience interconnectors, SEMD), exacerbated again by the ringfencing of expenditure with associated PCDs, negatively impacts on our ability to build the level of water security necessary to support our customer needs into the future.

1.18 These gaps in allowed expenditure are exacerbated by Ofwat's unduly punitive ODI regime and result in significant risk of base and enhancement overspend being necessary in order to maintain levels of service to customers and invest in resilience at a minimum acceptable level (without adequate return). This, in turn, challenges access to equity and financial capital which is necessary to support our PR24 investment programme.

Outcomes

1.19 The overall negative skew in the outcomes package is amplified as any extreme weather and/or significant operational events will affect several ODIs (typically water supply interruptions, C-Mex, BR-Mex, and leakage), resulting in cumulative penalties, especially prior to the delivery of our enhancement programme.

1.20 Of particular concern:

(a) Ofwat's water supply interruptions performance commitment level (**PCL**) of 5 minutes applies immediately, ignoring our company-specific circumstances and, importantly, the time required to deliver the investment necessary to achieve the PCL. It also comes with an unduly punitive ODI containing a -2% RoRE penalty collar (double that which applies to other companies, and four times the level of many other ODIs) without allowing for severe weather exemption. This is more 'downside' risk than SEW can bear; and

(b) The C-MeX methodology contains regional bias that unfairly penalises SEW.

1.21 In addition, Ofwat has applied a £3.9m reduction to our revenues related to the number of void (i.e. unoccupied and therefore non-chargeable) premises in the non-household (**NHH**) water retail market. This excessive penalty is unjustified, does not reflect harm suffered by consumers and stems from an inconsistent and unclear regulatory approach.

1.22 Overall, the PR24 FD results in the likelihood of an unsustainable level of cumulative penalties – many of which will be driven by factors outside of company control, e.g. extreme weather and associated peak customer demand.

Risk and return

1.23 Ofwat's estimate of the cost of equity in the PR24 FD is not risk-reflective and is underestimated due to technical errors and a failure to reflect the balance of evidence. As a consequence, the allowed return is not fair or commensurate with the returns that equity investors can obtain on comparable investment opportunities elsewhere.

1.24 In addition, the cost of debt is too low, does not fund efficient costs and does not reflect the specific characteristic of SEW as an historical infrequent issuer of debt.

1.25 Taken together, the result is an excessively low rate of return which adversely impacts SEW's ability to secure financial capital and maintain financial resilience. This is not in customers' interests given the reliance that PR24 places on support from investors for the industry's unprecedented programme of investment.

Financeability and investability

1.26 Under the PR24 FD, the notional company is not financeable or investable.

1.27 Given the low cost of capital and its high level of risk, the notional company cannot achieve the target credit ratings and is not resilient in a 'downside' scenario. Investors cannot expect to achieve the allowed return (so there is no 'fair bet'). This is inconsistent with Ofwat's statutory duties.

1.28 The risk mechanisms in the PR24 FD – in particular, the deadband applicable to the new Outturn Adjustment Mechanism (**OAM**) and the thresholds at which the Aggregate Sharing Mechanism (**ASM**) applies – also require adjustment to achieve a 'fair bet' and provide sufficient headroom under the financeability assessment.

CMA redetermination

1.29 It is for all these reasons that SEW has exercised its right to request a reference to the Competition and Markets Authority (**CMA**) for a new, independent review, as summarised in its letter to Ofwat dated 18 February 2025.

1.30 This is not a decision that has been taken lightly. However, the issues summarised above and set out in more detail in this Statement of Case are highly material to SEW and its customers.

1.31 We therefore welcome the opportunity that the CMA has to examine the challenge that we are facing with a 'fresh pair of eyes' and look forward to hearing the CMA Group's expert opinion. In forming this opinion, we invite the CMA to prioritise focus on the above issues as part of its redetermination and consider adopting the approach set out in Table 1.1 below. Table 1.1 also sets out our assessment of the impact of adopting this approach on current and future customer bills.

Table 1.1: SEW proposed approach and customer bill impact

Remedies	Bill Impact, Change £ (2029/30 vs 2024-25)
Ofwat PR24 FD Position	
Average household bill for SEW customers	+55 (to £287)
Costs	
Adjust Ofwat's **base** costs models, post-modelling adjustments, and Cost Adjustment Claims (**CACs**) to reflect the expenditure proposals in our PR24 Draft Determination Response (**DDR**), (subject to an uplift of £54m to reflect the higher mains renewals rate assumed in Ofwat's PR24 FD). This results in an additional PR24 funding allowance of approximately £129m for base.	14
Adjust Ofwat's **enhancement** costs allowances, by uplifting funding for specified enhancement lines as set out in Section 4 (Costs). This results in an additional PR24 funding allowance of approximately £227.4m for enhancement.	13
Amend Ofwat's **frontier shift** efficiency across base and enhancement costs to 0.5% p.a. from 1.0% p.a.	4
Outcomes	
Adjust the **WSI PCL** to take into account the timing of our investment programme and lower the **penalty collar** to -0.5% of RoRE.	N/A
Modify the calculation of company performance for **C-MeX** such that any inherent regional biases are removed.	N/A
Remove the unjustified £3.9m penalty for **NHH voids**.	1
Risk and return	
Revisit the calculation of the **Cost of Equity**, taking into account the evidence set out in the Cost of Capital Report, and select a point estimate which is at least 6.32%.	11
Revisit the calculation of the **Cost of Debt**, taking into account the evidence set out in the Cost of Capital Report, and implement an uplift of 56bps to the Cost of Debt, from Ofwat's PR24 FD allowance of 3.15% to 3.71%.	5
Aim up on the **Cost of Equity** by 44bps to reflect otherwise unmitigated skew on the PR24 FD's outcomes package.	4
Allow SEW a Company Specific Adjustment (**CSA**) on the **Cost of Debt** which reflects SEW's status as a small company that issues debt relatively infrequently.	2
Financeability	
Change the **ASM thresholds** to reflect a ±2.00% "lower" threshold at 50% sharing and ±3.00% "upper" threshold at 90% sharing.	N/A
Remove the ±50bps **OAM deadband**.	N/A

Total	+54 (to £341)[4]

Notes:

(1) The bill impact arising from the cost of capital is driven in part by the change in macroeconomic conditions, with c. £20 of the impact being driven by a change in underlying market data.

(2) No bill impact is presented for the WSI PCL and collar, C-MeX ODI, ASM thresholds or OAM deadband because this is contingent on company outturn performance.

1.32 Adopting this approach would allow us to deliver the specific range of investment supported by our customers, which has been designed to have a significant impact in terms of improving water security, service quality and resilience in our regions now and – as the foundation for continued investment in future AMPs – for the long-term. In addition, a secure and resilient supply of water is essential to support wider economic growth.[5]

1.33 For completeness – and in case of assistance to the CMA when determining its approach to the redetermination – SEW does not consider any of the following aspects of the PR24 FD to be in dispute:

(a) **Enhancement spend that is fully funded pre-frontier efficiency** (as the PR24 FD accepts our scheme costs, with efficiency considerations addressed separately in this Statement of Case);

(b) **The residential retail price control** (as the allowance in the PR24 FD closely matches SEW's PR24 Business Plan, consistent with our history of efficient cost management);

(c) **The form of the control for wholesale water including water resources, water network plus and the developer services activity adjustments** (as this is an established process with which we have no particular issues);

(d) **Cost sharing rates** (where our view is significantly aligned with the PR24 FD); and

(e) **PAYG and RCV run-off rates** (where our view is also significantly aligned with the PR24 FD – although we note that the CMA may wish to consider them as part of its financeability assessment and to update them as necessary in light of its redetermined costs).

1.34 Subsequent sections of this Statement of Case provide detailed explanations and supporting evidence in relation to each of the issues we have identified in Ofwat's PR24 FD, with a view to assisting the CMA to further the overriding objective. **Confidential information** is highlighted in accordance with the CMA's suggested colour coding for ease of reference (namely, blue highlighting for information which should not be shared with other Disputing Companies, green highlighting for information which should not be shared with Ofwat or other Disputing Companies or published and light grey highlighting for information which should not be shared with any third party or published). SEW has not needed to make use of either of the latter two categories and so the CMA will observe only blue highlighting in this Statement of Case.

1.35 We have engaged a small number of consultants to assist us in preparing this Statement of Case. A list of **expert reports** is as follows.

(a) ChandlerKBS: "Industry Cost Modelling Methodology & Service Reservoirs" (**the Service Reservoirs Costs Report**);

[4] This equates to less than £1 (94p) per day. This is broadly in line with the level of bill increase proposed in our PR24 business plan (£337), which gained 71% customer support.

[5] Independent Water Commission, 27 February 2025, Call for Evidence, page 178.

(b) Economic Insight: "Frontier shift at the PR24 Redeterminations" (the **Frontier Shift Report**);

(c) KPMG:

(i) "Estimating the Cost of Capital for PR24" (the **Cost of Capital Report**) annexing "PR24 Cost of Debt: Analysis of the Infrequent Issuer Premium" (the **Company Specific Adjustment (CSA) Annex**); and

(ii) "PR24 Final Determinations – Risk Analysis for a Notional Company" (the **Industry Risk Report**);

(d) Oxera:

(i) "Wholesale base expenditure modelling" (the **Base Costs Modelling Report**);

(ii) "Base cost adjustments and cost adjustment claims" (the **Post-Modelling and CACs Report**).

1.36 Please note that Frontier Economics have also assisted us in relation to enhancements and outcomes; and KPMG have assisted us in relation to company-specific risk analysis, operational headroom and financeability.

1.37 To assist the CMA, this Statement of Case also includes:

(a) a **Glossary** (at Annex A);

(b) a summary of the relevant **Legal and Regulatory Framework** (at Annex B). Whilst the legal framework for conducting a redetermination is well-established, we have – in case helpful – summarised Ofwat's relevant statutory duties and noted in each section of this Statement of Case which duties we think are particularly engaged (whilst recognising that the CMA will want to keep an open mind in this regard). Where relevant, we have also highlighted appropriate aspects of the UK government's current Strategic Policy Statement for Ofwat;

(c) **Initial Observations on Ofwat's Reference Documents and the 'Teach-in' Materials** we have seen and had an opportunity to consider (at Annex C); and

(d) a table clearly identifying any **'New' Material** (i.e. information post-dating that available at the time Ofwat made its PR24 FD) contained in this Statement of Case (at Annex J).

1.38 We note that the CMA can request that Ofwat extend the six-month statutory **timetable** for the reference (by no more than six months) if there are special reasons why the report cannot be made within this time. If the CMA is minded to make such a request, we would encourage the CMA to ensure the process is concluded with its final report(s) published by **15 December 2025.** This would ensure any resultant change from the process can be reflected in investment plans and customer charging in Year 2 of AMP8. This date is also in line with when Ofwat expects to publish any in-period ODIs to allow companies to incorporate any impact in customer charges.

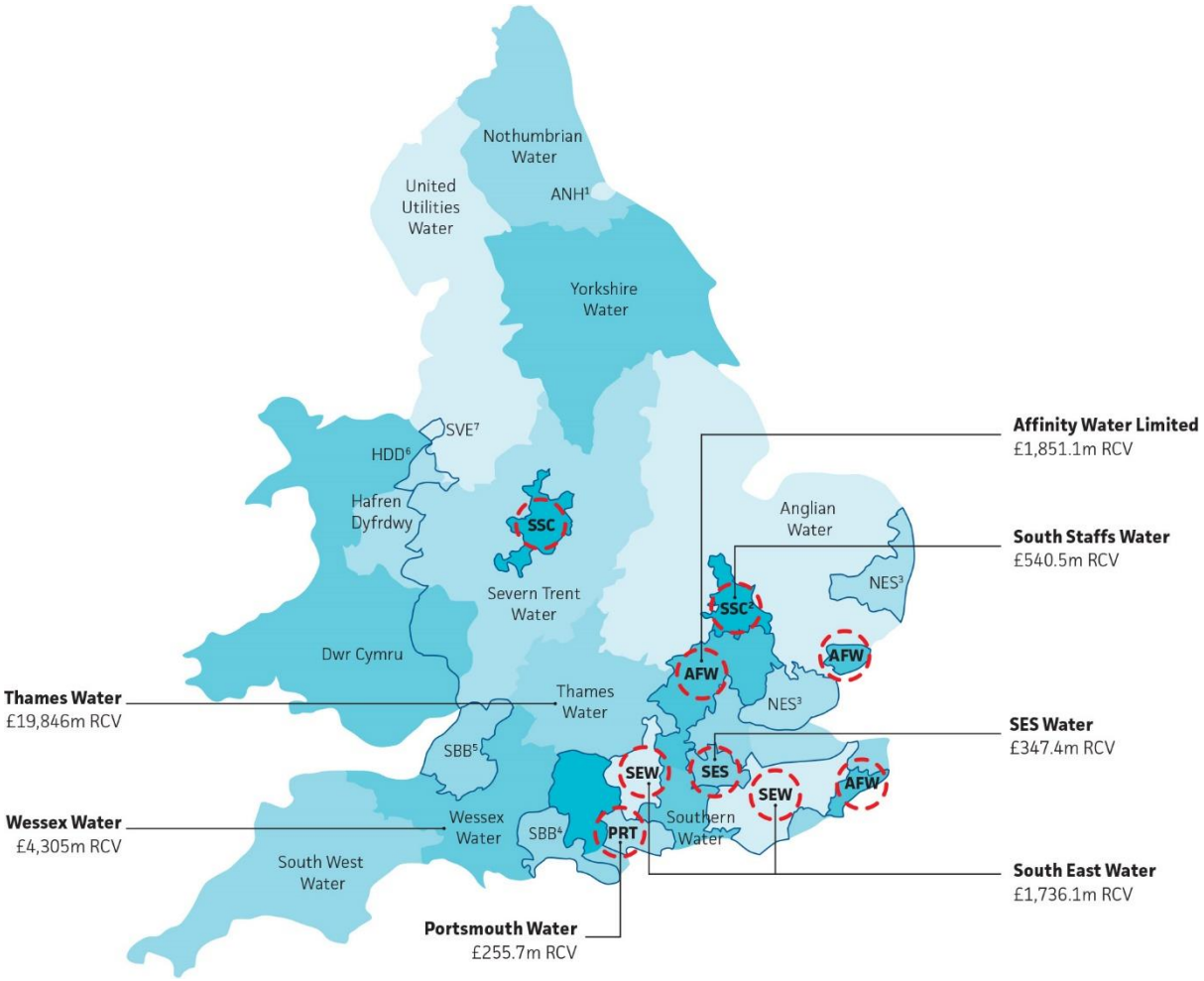
2 Our story

Who we are

2.1 SEW is a small regional company providing water services (not wastewater services) to 2.3 million customers in the 'seriously water stressed' south east of England.[6] In industry terminology, we are a **Water only Company** or **WoC** and 1,071 employees help us supply around 544 million litres of water per day using 9,000 miles of underground pipes.

2.2 SEW is the second largest of the five WoCs in England with a Regulatory Capital Value (**RCV**) of £1,736.1 million – but still 2.5 times smaller than Wessex Water (the smallest Water and Sewerage Company (**WaSC**) in England) and more than 11 times smaller than Thames Water.

Figure 2.1: Water companies in England and Wales[7]



What we do

2.3 SEW operates in accordance with its Instrument of Appointment (or **Licence**)[8] granted under the Water Industry Act 1991 (as amended) (**WIA91**) and economic, environmental and water quality regulations and frameworks enforced by Ofwat, the Environment Agency (**EA**) and the Drinking Water Inspectorate (**DWI**). We also work with a number of other organisations, including Natural

6 SEW operates within an area of serious water stress as designated by the Environment Agency, due to the south east of England's warm, dry climate and growing population. See Environment Agency, 1 July 2021, Water stressed areas: final classification (confirming that SEW's area remains an area of serious water stress as originally classified in 2013).

7 Ofwat, Contact details for your water company and Ofwat, 21 November 2024, Monitoring Financial Resilience Report 2023-24, page 13. RCV figures are stated as at 31 March 2024.

8 Ofwat, February 2025, Instrument of Appointment for SEW.

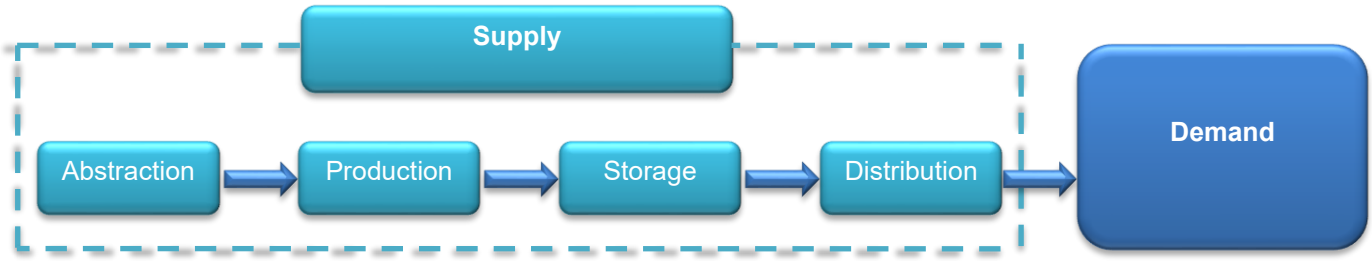
England (**NE**) (the UK Government's adviser for the natural environment) and the Consumer Council for Water (**CCW**) (representing water consumers).

2.4 Pursuant to its general duty under section 37 WIA91, SEW is required to maintain an efficient and economical system of water supply within its licensed area and to ensure that all such arrangements have been made (for providing supplies of water to premises in that area and for making such supplies available to persons who demand them, and for maintaining, improving and extending its water mains and other pipes) as are necessary for securing that SEW is and continues to be able to meet its obligations.

'Source to tap' system

2.5 At SEW, we operate a 'source to tap' system, with resilience required at each stage of the process, shown in Figure 2.2 below.

Figure 2.2: Our 'Source to tap' system



2.6 Further detail about each of these five stages is provided in Annex D (Supporting information). By way of high-level summary:

(a) Abstraction: SEW predominantly abstracts groundwater from chalk and sandstone aquifers via more than 250 boreholes, largely across the North and South Downs. 73% of our baseline supply is from ground water supplies, 19% is from surface water supplies and the remaining 8% (the highest in the industry) is comprised of bulk water imports from other companies.

(b) Production: Once abstracted, raw water must be treated at a Water Treatment Works (**WTW**). SEW operates 88 WTW close to its abstraction sites. This is a large number compared to other companies given the size of SEW's customer base and network. SEW also has many small WTW serving local areas.

(c) Storage: Once treated, water is pumped to reservoirs for storage. SEW has limited localised storage compared to other companies because SEW's storage systems were designed and developed to support SEW's small, local WTW. As population growth in the south east of England has increased, our service reservoir (**SR**) resilience has reduced. If the WTW fail, or cannot keep up with the level of customer demand, storage will deplete more quickly, increasing the risk of customer supply interruptions.

(d) Distribution: Water is distributed from storage to customers via SEW's network of mains. In SEW's supply area, water sources are generally at low elevation – so this typically involves pumping water from low-lying WTW to service reservoirs located in upland areas. Due to SEW's history of merging multiple smaller water companies (see further below), our local network systems have limited interconnectivity.

(e) Demand: Our customer base across Kent, Sussex, Berkshire, Hampshire and parts of Surrey is predominantly domestic, with 95% of supply points being household (**HH**) customers. Non-household (**NHH**) customers – including those in the agricultural sector – represent just 5% of supply points but account for over 10% of water usage. We have a strong focus on demand management and are the most metered company in the industry following the delivery of our universal metering programme in AMP5 and AMP6. Peak

demand is a key factor for SEW, i.e. where we experience large increases in demand from both HH and NHH customers during extreme weather events.

Balancing supply and demand

Patterns of demand and supply

2.7 With regard to achieving supply-demand balance, it is important to understand patterns of demand and supply and the difference between the average water demand and the peak water demand in SEW's supply area.

2.8 Patterns of water consumption vary significantly seasonally with weather patterns and with different regional impacts. Sustained hot, dry periods can see demand typically increase by 20% with some agricultural areas increasing by over 30% with irrigation and livestock demands. Demand patterns also vary within each week – with more demand at weekends with more people at home – and daily with a diurnal pattern of higher demands in the morning and evening and lower demands overnight. These daily diurnal patterns can generally be accommodated within our treated water storage systems, but prolonged seasonal demand patterns can only be met through increased production capacity and/or storage.

2.9 Given these variations, peak water demand (i.e. the highest level of demand in a system over a short period of time) can significantly exceed the average level of water demand measured over the course of a day/week/month/year. Further relevant information is included at Annex D (Supporting information).

Water Resource Management Planning

2.10 Water companies are required by statute to set out how they intend to balance supply and demand over the next 25 years in a WRMP published every five years. In preparing a WRMP, we must follow a process laid down in sections 37A-37D WIA91 and relevant secondary legislation,[9] supported by guidance from the EA on the methodologies we must employ in calculating the various parameters.[10]

2.11 However, WRMP planning guidelines only consider supply-demand balance at a Water Resource Zone (**WRZ**) level (see further below for a description of our eight WRZs) and do not adequately take into account extreme weather events or supply-demand balance at a lower, sub-zonal level. We have engaged with the EA to explain the need for amendment in this regard. This means that we must make an additional case for investment to Ofwat in respect of any more local, sub-zonal issues.

2.12 Further details on SEW's latest WRMP (**WRMP24**) – and how it relates to Ofwat's PR24 price control – are set out in Annex D (Supporting information).

WRMP Target headroom

2.13 Our supply-demand balance includes an allowance for calculation uncertainty, known as target headroom. Target headroom provides a legitimate, but limited, planning buffer for forecast accuracy in the main building blocks of our WRMP. It is not surplus capacity to deal with unforeseen risks and shocks.

2.14 Specifically, target headroom is defined as *"the minimum buffer that a prudent water company should allow between supply and demand to cater for specified uncertainties (except those due to outage) in the overall supply demand balance*".[11]

---

9 This includes the Water Resources Management Plan Regulations 2007 and any ministerial directions given under this legislation.

10 UK Government, 14 April 2023, Water resources planning guideline.

11 UK Water Industry Research, 2002, An improved methodology for assessing headroom, page 13.

Network capacity

2.15 Network capacity is also important to understand in the context of achieving supply-demand balance. This does not refer to the availability of raw water (which is, as set out above, addressed by the WRMP framework) but rather to a company's ability to treat and distribute water, including via storage and interconnected water transfers.

2.16 Put simply, if WTW maximum output plus storage (and any water which can be transferred via network interconnectivity) exceeds demand, our customers will maintain supply. However, if WTW maximum output plus storage (and any water which can be transferred via network interconnectivity) is less than demand, first we deplete our storage levels and then our customers ultimately lose supply.

2.17 Network capacity analysis has not been a focal point within the regulatory regime since privatisation because, at the time most assets were initially constructed, capacity comfortably exceeded demand. It is therefore not well understood by industry and regulators. As network capacity constraints are a significant issue for SEW and drive our supply resilience strategy, we have sought to increase industry understanding – including engaging with Ofwat on the subject before and throughout the PR24 price review process: see Annex D (Supporting information).

Regulating for resilience

2.18 There are currently no water resilience standards by which our regulators can assess and benchmark network capacity enhancement schemes.

2.19 The National Infrastructure Commission (**NIC**) (soon to be merged with the Infrastructure and Projects Authority (**IPA**) to form the National Infrastructure and Service Transformation Authority (**NISTA**)[12]) has independently confirmed the existence of gaps in water resilience standards in a September 2024 report.[13] Details of the NIC's findings are set out in Annex D (Supporting information) but key points include that there are *"**notable gaps in expected resilience to peak water demand and in water resource system redundancy**"*[14] and that *"**Without a clear target to aim for, the need for resilience spend could be challenged by regulators trying to manage upward pressure on bills**"*.[15]

2.20 The NIC describes the peak water demand and network capacity issue as follows:

> *"Water resource systems rely on treatment works treating water continuously, but consumers do not use water at the same volume across a week because usage often looks different on a weekday compared to a weekend and in the daytime compared to the middle of the night. Treated water is therefore stored in service reservoirs so it is available to be put into supply when it is needed. If demand outstrips supply over a long hot period, as was seen in summer 2022, then it is possible that service reservoirs will run out of water and treatment works will not be able to treat and store enough water to supply households. The ultimate result is consumer loss of water supply. This creates the real risk that while the Commission's estimated £21 billion programme of investment in long term drought resilience will deliver enough raw water to meet needs over a dry summer, water companies may not be able to treat and put this water into supply fast enough to meet daily or weekly demand."*

2.21 In line with the NIC's recommendations, Department for Environment, Food and Rural Affairs (**Defra**), Ofwat, the EA and the DWI are currently in the process of considering the gaps highlighted. SEW is contributing to this workstream – including putting forward metrics for Peak Demand Headroom, Storage and Single Source of Supply (**SSO**). These are further described in Annex D (Supporting Information).

---

12 UK Government, 10 October 2024, Chief Secretary to the Treasury sets vision for future of Britain's infrastructure.
13 National Infrastructure Commission, September 2024, Developing resilience standards in UK infrastructure, pages 27 and 28.
14 National Infrastructure Commission, September 2024, Developing resilience standards in UK infrastructure, page 26.
15 National Infrastructure Commission, September 2024, Developing resilience standards in UK infrastructure, page 27.

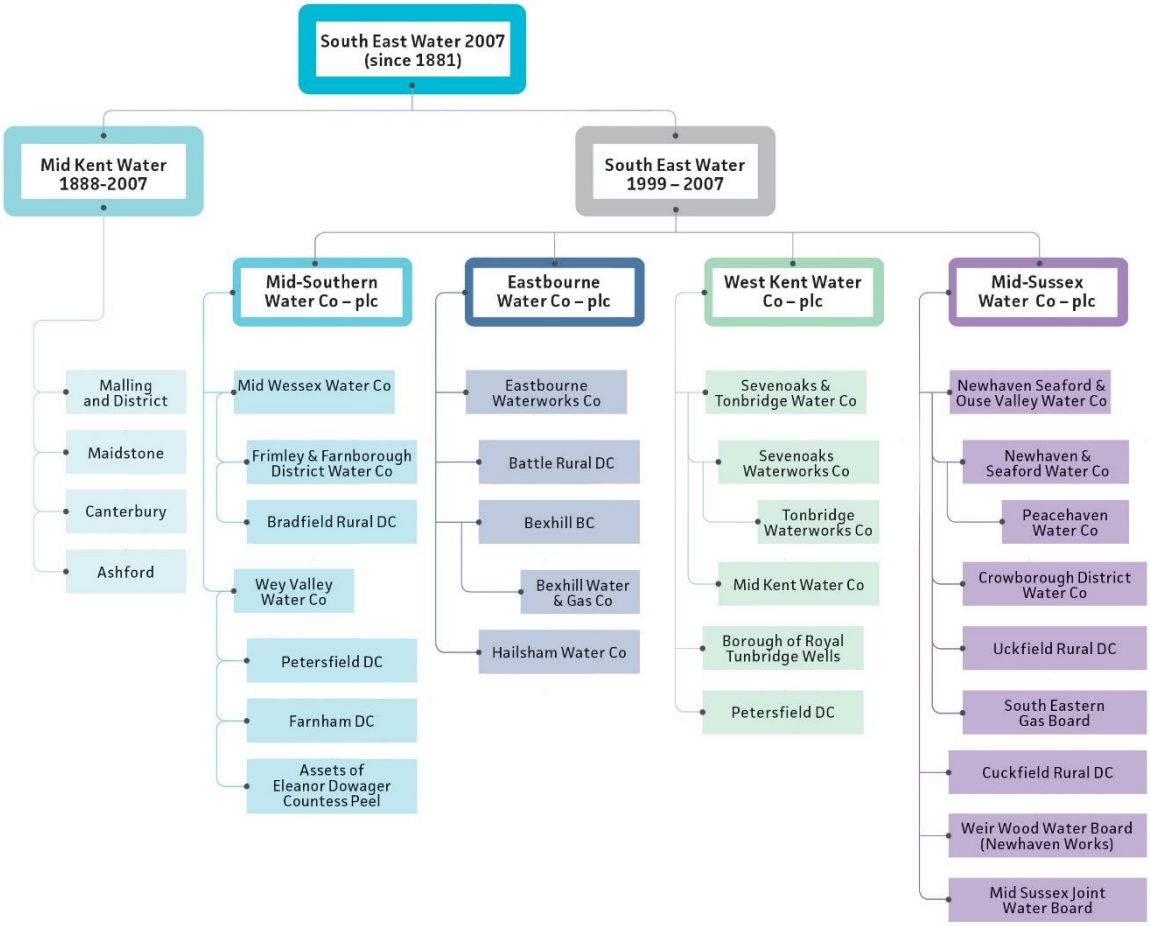
2.22 In addition, we include at Annex E (Growth and resilience) a note exploring how growth and resilience have been funded at PR24 and in previous price controls (as the approach to funding and the regulatory treatment of costs has changed significantly over time).

Our history and regions

2.23 SEW is the product of an amalgamation of many smaller local water companies over a long period of time. We have always been privately owned – built up from mergers and acquisitions, some of which date back to the nineteenth century.

2.24 In its current form, SEW is the result of the merger of five former water companies in the south east of England. Four smaller companies were merged after privatisation in the 1990s.[16] The present company came into existence in December 2007 when the assets, rights and obligations of Mid Kent Water were transferred to South East Water and the latter's supply area was extended accordingly.[17]

Figure 2.3: SEW Overview



16 South East Water was established in 1992 when SAUR Group (then part of French group Bouygues) brought together three local water companies: Mid Sussex Water, Eastbourne Water, and West Kent Water. In 1999, the company merged licences with Mid Southern Water to form SEW.

17 Competition Commission, 1 May 2007, South East Water Ltd / Mid Kent Water Ltd merger inquiry (CC).

2.25 SEW therefore operates – in accordance with its Licence – across three distinct operational regions: **Western** (Hampshire, Berkshire, Surrey and formerly known as Mid Southern Water), **Sussex** and **Kent** (adjacent to each other).[18]

2.26 Our historical make up is important in understanding our operational circumstances and the resilience challenges we face. As we are formed through a collection of smaller companies merged into one, interconnectivity is a key issue and we do not, unlike many other companies formed from government-owned water boards, have the benefit of a strategic grid arrangement or a company with a network optimised from the outset.

2.27 In addition, it is difficult to find suitable routes for interconnections because we have large areas of environmental significance (over 44% of our supply area lies within a National Park or Area of Outstanding National Beauty) and significant transport infrastructure crossing our area including the Channel Tunnel rail link and various motorways (e.g. M3, M4, M20, M23 and M25).

WRZs, Water into Supply Zones (WISZ) and sub-zones

2.28 We divide our three regions into eight Water Resource Zones (**WRZs**), 72 Water Into Supply Zones (**WISZ**) and 'sub-zones'. This helps us: understand and plan water resources; manage supply, demand and leakage; and identify investment priorities.

2.29 SEW's main challenges and constraints are at sub-zonal level, which require regional level planning linked to sub-resource zone level investment. A sub-zone can be a local town or village supplied by a simple arrangement of one or two WTW and associated service reservoirs.

2.30 Further information on our WRZs, WISZs and sub-zones is included in Annex D (Supporting information).

Investing for resilience

2.31 As each of our regions has specific characteristics – determined by history, different river catchments, geology, topography, demography, weather, ecology and land use – the investment SEW needs to make to maintain a resilient, efficient and economical supply to our customers differs.

Table 2.1: Specific characteristics by region

	Western (West)	Sussex (Central)	Kent (East)
Abstraction			

[18] These regions are also sometimes referred to as West, Central (Sussex) and East (Kent).

	Western (West)	Sussex (Central)	Kent (East)
Production	[redacted]	[redacted]	[redacted]
Storage	[redacted]	[redacted]	[redacted]
Distribution	[redacted]	[redacted]	[redacted]
Demand	[redacted]	[redacted]	[redacted]

Our geography

2.32 As seen from the above, our geography and geology is an important part of what makes SEW unique. Combined with shifts in customer behaviour and accelerating climate change, it also presents us with some unique challenges.

2.33 In particular, there are seven company-specific factors which it is important to understand:

(a) First, chalk and sandstone aquifers dominate the south east of England and, historically, resulted in village boreholes. Consequently, we have a large number of small sources (more than 250 boreholes, six rivers and six raw water service reservoirs) and 88 WTW that abstract relatively low volumes of water. This makes us different from most other companies who do not share the same kind of geology and, instead of relying on boreholes, have developed large surface water-fed treatment works, supplying large populations. We therefore face different and greater resilience challenges than other companies with a different profile of water sources (including difficult-to-treat sources such as greensand sources with high levels of manganese and iron). We also incur higher costs given – among other things – our greater number of pumps, booster pumps and associated power usage.

(b) Second, we have limited localised storage compared to other companies, which increases the risk of supply interruption during extreme demand surges. This is because our storage systems were originally designed and developed to support our small local WTW and, accordingly, sized to the feeding WTW capacity, i.e. to provide an appropriate local buffer but ensure water is not stored too long, which is a water quality risk.

(c) Third, we are a long-standing designated area of serious water stress by the EA and have the highest percentage of treated water bulk supplies – i.e. water supply purchased from a neighbouring water company – in the industry at 8% (industry average of 2%).

(d) Fourth, as south-east England is non-industrialised, there has not been any 'deindustrialisation windfall' for SEW in terms of freeing up network capacity built for industrial customers to provide capacity to handle new housing developments (with even the lightly industrialised parts of the south east of England not within our supply area). Headroom has therefore been continuously eroded since the system was built.

(e) Fifth, there has been very high population and housing growth in south-east England. Housing development has been faster in our region than any other and, as our region lacks major cities,[19] this is mostly occurring in areas lacking the kind of grid networks that provide flexibility of supply choices in periods of peak demand.

Table 2.2: Regional distribution of house building in England 1990-2019[20]

North East	196,740
North West	498,360
Yorkshire and The Humber	384,750
East Midlands	425,890
West Midlands	406,490
East of England	562,310
London	539,910
South East	751,880
South West	509,840

[19] Looking at UK cities by size (see World Population Review, United Kingdom Cities by Population 2025), none of the 79 largest cities are in our regions. The 80th largest city is Eastbourne in Sussex (pop. 118,000). This clearly shows the 'unurbanised' nature of our supply area.

[20] Office for National Statistics, 29 January 2025, Indicators of house building, UK: permanent dwellings started and completed by country.

(f) Sixth, our region – with few commercial centres but a key commuter area to London – has been significantly affected by the shift in working pattern following the Covid-19 pandemic. We have seen a substantial increase in peak demand for water, especially in commuter towns where demand that would previously have been on Thames Water has shifted to us as a result of home working. In addition, behavioural change since the pandemic has seen a greater focus on leisure activities and local rather than foreign travel, increasing summer water demands.

(g) Seventh, our supply area is agriculture heavy (with 13% of our non-household customers in the agricultural sector compared to less than 5 per cent. for all other Water Resources South East (**WRSE**) companies[21]), including soft fruit and salad production in Kent and Sussex. Agriculture is highly water-intensive and the longer drier periods has meant farmers are resorting to using mains water more frequently to ensure crops remain viable.

2.34 All of these factors are outside company control and contribute to the challenges we face in balancing supply and demand and ensuring resilience for our customers. Further information on these factors is provided at Annex D (Supporting information).

Our performance

2.35 Despite these challenges, our performance during 'normal' weather conditions has historically been good. During AMP6, covering the period 2015-2020, our service quality performance measured by the net reward or penalty across the period was close to zero. This means our supply system was broadly delivering the service expected by customers and Ofwat at an efficient level of costs during this period.

2.36 In addition, our **Western** region is an upper quartile performer on water supply interruptions and has a low level of customer complaints. As set out above, this region differs from our Sussex and Kent regions in terms of better network interconnectivity (with fewer single points of failure) and supply demand headroom to withstand peak demand – but with all other factors under company control consistent across the three regions, e.g. executive team, planning and management, expenditure profile, incentive structures, asset maintenance, contractors, policies and procedures.

2.37 Across all of our regions during AMP7:

(a) We show **good overall performance across many metrics** (e.g. water quality, environment, vulnerability).

(b) We missed our **leakage** target for the first time in 15 years as a result of extreme weather events in 2022 and customer leakage (having historically been one of the strongest industry performers in this regard). We implemented a leakage recovery plan and are delivering a comprehensive programme of work to assist our target recovery, which is in addition to our substantial leakage commitment in the year. We are aiming to return to our target leakage level during 2025.

(c) We have achieved a reduction in **per capita consumption** but (in line with all companies across the industry) not met the stretching performance commitment level (**PCL**) imposed by Ofwat at PR19.[22] However, since this PCL was set a series of factors – including fewer

[21] WRSE is an alliance of the six water companies that supply drinking water across the south east of England – namely Affinity Water, Portsmouth Water, SEW, SES Water, Southern Water and Thames Water (see Water Resources South East, Our Members). WRSE adopts a regional approach to managing water resources and works collaboratively with government, regulators and stakeholders to develop a regional plan. Water company WRMPs must be consistent with that regional plan and all plans (regional and WRMPs) are reviewed by the EA.

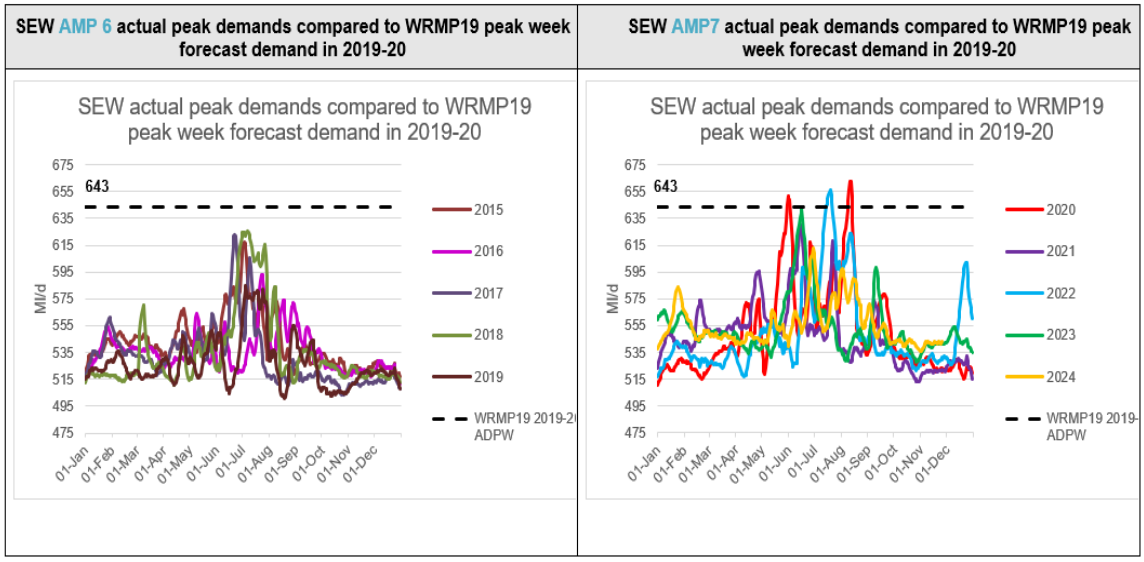
[22] Ofwat, 24 February 2025, Ofwat's Fourth Climate Adaptation Report, pages 13 and 14, states in this regard: "*With regard to per capita consumption (PCC), all but two companies have reported an annual reduction in per capita consumption and both annual and three-year average consumption is now lower across the sector than the 2019-20 baseline. Despite this, no companies have currently met their performance commitment level across the 2020-25 period to date and achieving 2024-25 targets is now very unlikely for some companies. We commissioned research to better understand the impacts of Covid-19 on PCC performance which was cited as a key reason for PCC performance impacts.*"

people commuting out of our supply area during the working day – have impacted the way that water is used by our customers and, for reasons discussed further below, customers seem less responsive to water efficiency messaging.

(d) We have beaten our target for **mains repairs** three years out of five during AMP7, with the exceptions being narrow misses as a result of extreme weather (including a hot, dry summer and freeze-thaw in winter, leading to higher numbers of mains bursts than normal across the industry).

2.38 However, our **water supply interruptions** performance in AMP7 has been significantly adversely impacted by the real increase in demand above the peaks properly (as per the relevant guidance) assumed in the WRMP process. Outturn demand has also outstripped the most cautious planning models from our PR19 business plan due to external factors outside the company's control, in particular the combination of 'new normal' (i.e. the shift in working pattern following the Covid-19 pandemic, with commuters staying at home and general behaviour changes) and an unprecedented frequency of extreme weather events.[23] This step-change in peak water demand in our regions following the Covid-19 pandemic is clearly illustrated by the following and more fully described in Annex D (Supporting information).

Figure 2.4: SEW's step change in actual peak demands compared to WRMP19

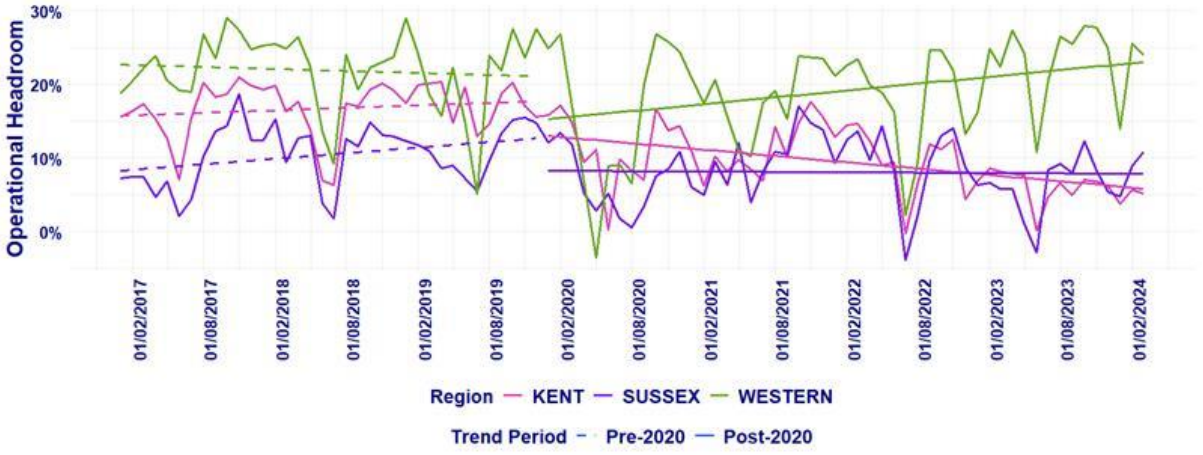


2.39 This unforeseeable increase in demand has, notwithstanding SEW's focus on installing metering (as mentioned above, we are the most metered company in the industry) and demand management, had a severe impact on operational headroom and the company's ability to cope with demand surges.

2.40 The following illustrates the widening disparity in operational headroom levels between SEW's Western and Kent and Sussex regions. The Western region has consistently maintained higher and more stable headroom, ensuring greater resilience in fluctuations in demand. In contrast, headroom in Sussex and Kent shows a statistically significant downward trend since 2020 indicating accelerating deterioration. This sustained decline reflects underlying capacity constraints, where demand growth – without corresponding increases in supply – has progressively eroded available headroom. Further details on operational headroom are included in Annex F (Outcomes and Water Supply Interruptions) at Part B (Further detail on WSI performance).

[23] For example, the 'Beast from the East' freeze-thaw in 2018, the heatwave in August 2020, the heatwave and freeze-thaw in 2022, the hottest June on record in 2023, and Storms Eunice (February 2022), Ciaran (November 2023) and Isha (January 2024).

Figure 2.5: Average monthly operational headroom by region



2.41 Our stretched local supply-demand balance in Kent and Sussex isolates the areas with the worst balance and leads to 'hotspots' with the same customers affected each time – typically those on the ends of linear network systems or those areas with low storage and production capacity running close or lower than peak demand. It is these isolated, long-term supply interruptions which underlie our performance and led to the launch of Ofwat's supply resilience investigation in November 2023.[24]

2.42 SEW has reviewed and learned lessons from each supply interruption incident – focusing on prevention, mitigation and response – and listened carefully to our customers. We have developed and implemented an action plan comprising a set of schemes which have already improved our supply resilience. These are addressed in more detail in Annex D (Supporting information). However, these short-term responses are no substitute for 'root cause' action which must, by its nature, scale and the time required for design, planning and delivery, be included in our multi-year investment programme for AMP8. Our carefully considered and researched 'root cause' proposals are included in our PR24 Business Plan and addressed further below.

Our focus on resilience

2.43 SEW has identified lack of adequate funding for growth in successive price reviews, repeatedly asking for investment with a focus on adding interconnections and network capacity. We have also been proactive and consistent in raising our network capacity issues with Ofwat at both senior and working level and driving forward emerging understanding, as set out in more detail in Annex D (Supporting information).

2.44 However, as SEW's supply area is mainly rural in nature – villages rather than cities – it has been difficult to present the type of large capacity enhancement scheme that Ofwat is able to more easily understand and benchmark. Our experience is that Ofwat has struggled to assess our network capacity enhancement schemes due to the absence of resilience standards and comparisons and the fact that the issue is not industry-wide (as the optimal solution is a number of smaller resilience / supply interconnector schemes and increased storage rather than a large strategic grid main or similar). There has also been an unhelpful lack of clarity in terms of the dominant mechanism for presenting and understanding capacity enhancement schemes as between the WRMP and the price review process.

2.45 Instead, past WRMP processes and recent price reviews have relied extensively on demand management (i.e. a push for increased metering and introducing ODIs relating to per capita consumption) with limited or no contingency. Effectively, the regulatory framework assumed that

[24] Ofwat launched an investigation into our supply resilience in November 2023 following the high demand incidents the company experienced in 2022 and 2023. Since the investigation was launched, we have entered into a constructive and transparent dialogue with Ofwat with a view to further demonstrating the challenges we face in providing today's public water supply in Kent and Sussex.

demand reductions would be sufficient to maintain supply headroom – even as demand grew – and without implementing an effective means of measuring or monitoring it.[25] This assumption has been proved wrong.

2.46 Specifically:

(a) Whilst SEW was encouraged to – and did – introduce universal metering over a decade ago (in place of new supply as the 'least cost' option under the WRMP framework), that has not delivered the forecast decrease in peak demand.

(b) Rather, it has become clear from our experience that, contrary to regulatory assumption, metered customers are in fact less sensitive to reducing demand during dry periods because they know they are paying for any water volume used.

(c) So, while the introduction of metering and other demand reduction initiatives had some initial effect in terms of reducing levels of demand in 'normal' times, it has not reduced peak demand. On the contrary, our experience is that we have seen an increase in demand in peak periods of hot weather from our metered customers.

(d) In the absence of measures to improve supply, this leaves SEW with a low level of network capacity compared to peak demand. Further, as a result of that reduced capacity, it takes time to refill the network from predominantly groundwater-fed, licence-constrained, existing treatment works – which in turn leads to prolonged interruption times.

2.47 We have also taken opportunities to put forward accelerated investment schemes, unfortunately without success. In the context of Ofwat's most recent refusal of our water resilience schemes before PR24 (designed to solve local headroom issues by sharing resources more evenly around the area) as part of its Accelerated Infrastructure Delivery Project,[26] we have been explicit that we are concerned about regulatory failure to recognise the urgent need for investment to improve resilience of service to our customers and "*are keen to avoid another periodic review where this issue is not addressed*".[27]

2.48 Consistent with the above, we have seen the progressive erosion of headroom in our water supply system, which has made us less resilient to the unprecedented surge in demand and frequency of extreme weather events since 2020. Importantly, this is despite forecasting to overspend our PR19 FD allowance for 2020-25 by £96m (in 2022/23 prices). This overspend includes delivery of the additional resilience schemes in our action plan, as set out in Annex D (Supporting information).

Our PR24 business plan

2.49 Against this backdrop, we have worked hard to develop our PR24 Business Plan on a regional basis – down to sub-zone level – with a view to ensuring that the unique challenges and circumstances of each of our regions are clearly understood and addressed, in line with our customers' needs and expectations, from this point onwards.

2.50 Key aspects of our plan and interactions with Ofwat during the price review process are described in Section 3 (Our PR24 plan for resilience).

[25] To note that WRMP24 has introduced 'adaptive pathways' enabling companies to plan for different future 'pathways' based on different (high/medium/low) forecasts for population growth, Environmental Destination (reductions in supply for sustainability reasons) and climate change impacts. See SEW, WRMP24 Supply-demand balances and adaptive planning (October 2024) for further details. This approach does not address shorter term (within AMP8) uncertainties, but is an improvement on previous WRMP frameworks.

[26] Ofwat, Accelerated Infrastructure Delivery Project.

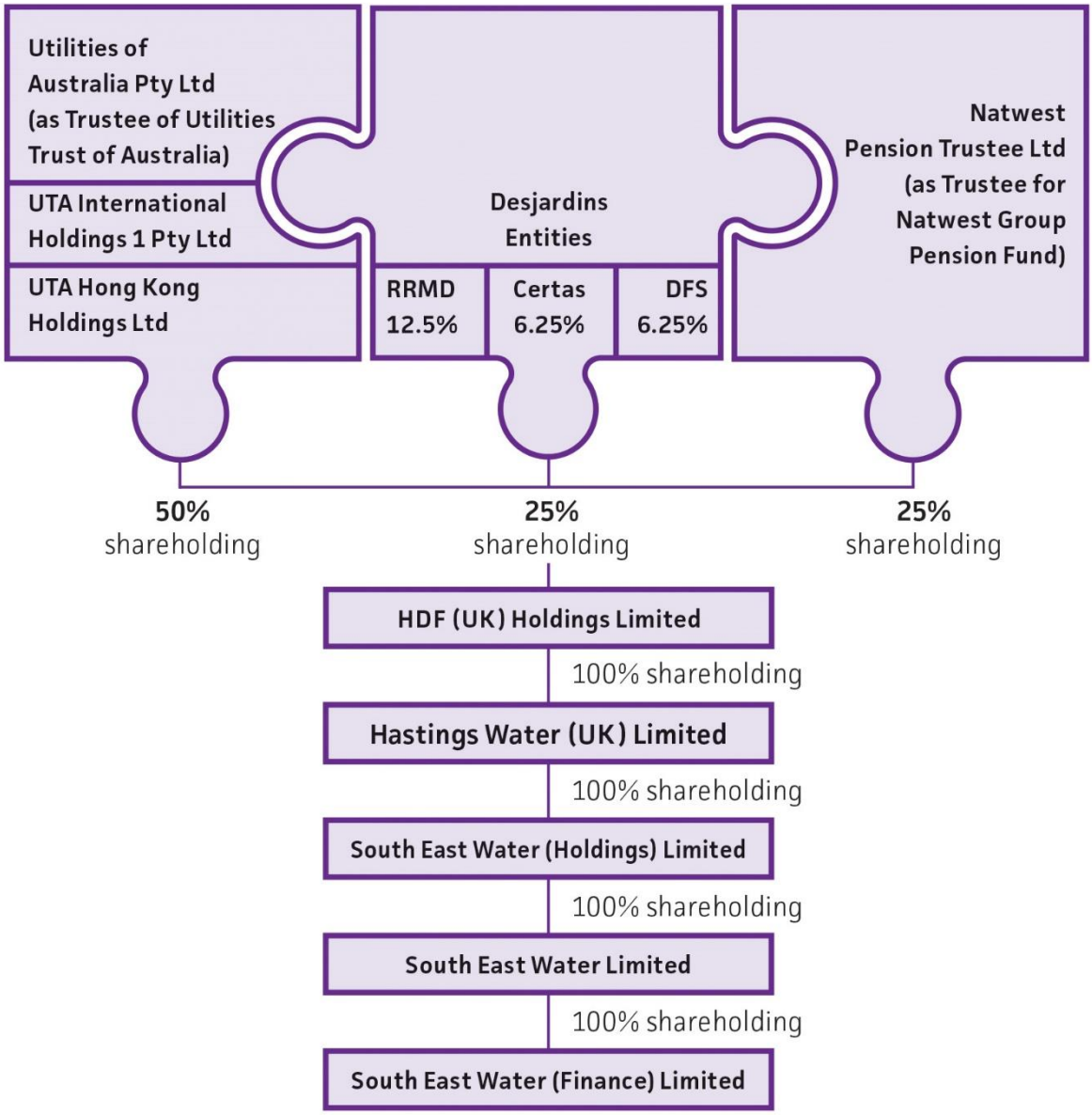
[27] Letter from SEW to Ofwat (David Black) dated 20 April 2023 regarding the Accelerated Infrastructure Delivery Project and Accelerated Schemes.

Our shareholders

2.51 SEW is the main operating company in the group of companies headed by HDF (UK) Holdings Limited (**HDF**). There are two intermediate holding companies between SEW and HDF, both of which, together with HDF, are registered and resident in the UK.

2.52 The ultimate owners of HDF – our shareholders – are **Utilities of Australia Pty Ltd** (as Trustee of Utilities Trust of Australia) (**50%**), **NatWest Pension Trustee Ltd** (as trustee for the NatWest Group Pension Fund (Main Fund Section)) (**25%**) and three entities of the **Desjardins** cooperative financial group based in Quebec (Régime de Rentes du Mouvement Desjardins, Desjardins Financial Security Life Assurance Company and Certas Home and Auto Insurance Company) (**25%**).

Figure 2.6: Group of companies



2.53 Our shareholders support our PR24 Business Plan and our drive to improve resilience. Since 2019, our shareholders have invested over £200m into SEW and our holding company – with an additional £75m invested in December 2024 as further described below.

Our financing and dividends

2.54 SEW's financing group (comprising SEW, South East Water (Finance) Limited and South East Water Holdings Limited) borrows from lenders within a Whole Business Securitisation (**WBS**), which ensures we have strong mechanisms in place to support SEW's financial resilience, such as a cash lock-up mechanism if certain financial ratios are breached and requirements to avoid debt maturity concentrations.

2.55 SEW's shareholders target a strong BBB/Baa2 credit rating, but this has been challenging during AMP7. As well as dealing with the macroeconomic consequences resulting from the global pandemic and war in Ukraine:

(a) Industry experience during this period has confirmed that Ofwat's PR19 price control was miscalibrated. All companies have overspent against their PR19 water totex allowances and almost all companies have suffered net penalties on ODIs (taking 2023-2024 – the latest year for which data is available – as an example, 13 out of 17 companies have net RoRE penalties on ODIs)[28] despite the industry delivering improvements in outcomes in absolute terms.

(b) SEW, despite being middle ranked in Ofwat's base cost models for PR24,[29] has suffered a loss of more than -2.5% of annual RoRE due to overspending so far during AMP7 and has paid net ODI penalties amounting to more than -1.25% of RoRE.[30] In large part, this ODI underperformance stems from the water supply interruptions ODI.

(c) We have restricted dividends accordingly (our dividend yield was only 0.6% in 2024),[31] but our gearing – which was previously trending down – has begun to creep up (77.8% at 31 March 2024).[32]

(d) Our credit rating has also come under pressure as a consequence of the sector's financial under-performance and the rating agencies' broader response to the loss of stability and predictability in the sector's regulatory regime.

(i) Moody's downgraded SEW by one notch from Baa2 to Baa3 in November 2024, with the rating under review for downgrade, the minimum for investment grade.

(ii) Standard and Poor's downgraded SEW by one notch from BBB to BBB- in February 2025, with the credit rating placed on CreditWatch negative.

(iii) Moody's affirmed the Baa3 credit rating, with a negative outlook, in March 2025, reflecting its view that SEW has received one of the most challenging determinations in the sector for AMP8 and will overspend against its cost allowances and accrue sizeable financial penalties on ODIs, absent the CMA making material changes to its regulatory settlement.[33]

(e) In December 2024, our shareholders invested £75m in SEW in order to maintain gearing in line with an investment grade credit rating (in recognition of Moody's revised guidance published in November 2024) and improve our liquidity position (in recognition of both rating agencies' liquidity requirements for a company with an investment grade credit rating). This investment is separate to the commitment made by our shareholders to inject equity of £75-125m into SEW, conditional on an appropriate risk return balance in the PR24 FD.

---

28 Ofwat, October 2024, Water Company Performance Report 2023-24, page 28.
29 SEW is ranked 8th on wholesale water triangulated costs in Ofwat's base models for PR24 (see Ofwat, December 2024, PR24 Base costs water model 3).
30 Ofwat, October 2024, Water Company Performance Report 2023-24, page 28.
31 Ofwat, 21 November 2024, Monitoring Financial Resilience Report 2023-24, page 13.
32 Ofwat, 21 November 2024, Monitoring Financial Resilience Report 2023-24, page 13.
33 Moody's, 4 March 2025, Moody's Ratings maintains negative outlook on South East Water; affirms Baa3 ratings.

3 Our PR24 plan for resilience

3.1 We built our PR24 Business Plan with a clear focus on addressing the root causes of the resilience challenges we have experienced – and which have impacted our customers – in AMP7.

3.2 It is the most ambitious plan we have ever produced, designed to restore operational resilience and improve our financial resilience – supported by a reduction in gearing – whilst investing in increased network connectivity and localised storage to tackle the growing threat from accelerating climate change and extreme weather risks and ensuring that customer bills remain affordable for all.

3.3 Specifically, we proposed:

(a) Investment of nearly £2 billion of totex over AMP8 in a range of schemes across each of our regions. This included schemes for increased treated water storage, efficient water movement between zones, the design and initiation of construction of a new raw water reservoir and WTW at Broad Oak (Kent), installation of pipelines to transport water from Broad Oak to surrounding areas effectively, and commencing early design and associated works to either construct a second reservoir in Arlington (Sussex) or implement a water recycling project in the vicinity. We also proposed making improvements to the connectivity of the primary WTW in Barcombe;

(b) To reduce peak demand by commencing installation of approximately 275,0000 smart meters (increased to 298,000 in our DDR), implementing a smart water network, utilising innovation to reduce demand and leakage and taking action to improve raw water quality; and

(c) To limit the impact on customer bills by financing a significant proportion of the investment through raising capital from our lenders and shareholders, ahead of payment by customers in future years, and a wider range of affordability support for our customers.[34]

3.4 Our PR24 Business Plan and supporting documents are published on our website.[35]

3.5 This section summarises, to assist the CMA, how we went about building and refining our PR24 Business Plan, including our engagement with customers and other stakeholders and our key interactions with Ofwat during the price review process.

Building our plan

3.6 The business planning process we put in place was designed to address the operational resilience issues we have experienced in AMP7 and provide what our customers have told us they want – a reliable, high quality water supply. It was also designed to meet the challenges of the statutory frameworks and Ofwat's PR24 Final Methodology,[36] and so that our analysis and proposed solutions were tailored to the unique characteristics and issues of our three distinct regions. Consistent with this approach, our PR24 Business Plan was built up at regional level by component and then assessed overall for deliverability and financeability.

3.7 Our work was captured in a set of key publications, namely: our Strategic Direction Statement (**SDS**), Long-Term Delivery Strategy (**LTDS**), long-term plans including our WRMP and our PR24 Business Plan.

[34] For example, providing enhanced financial support to vulnerable customers including a new and extended social tariff that will benefit more customers, a range of measures to help eligible customers enrol for our support tariff and avoid or get out of debt, and a six-point plan to reduce water poverty by 2030.

[35] SEW, Our Business Plan 2025-2030.

[36] Ofwat, December 2022, Creating tomorrow, together: Our final methodology for PR24.

Figure 3.1: Our PR24 Business Plan publications

Document	Purposes
Strategic direction statement (SDS)	Sets corporate direction and ambition, priorities, targets and aims to 2050
Long-term delivery strategy (LTDS)	Profiles performance improvements, core and adaptive plans to achieve 2050 ambition with trigger and decision points
Corporate long-term plans	A set of subject based longer-term plans, mix of statutory and internal, the Executive desire to consolidate and prioritise these
2025 to 2030 Business plan	Published investment plan for 2025 to 2030 including performance targets, schemes, bill rises and customer protections – sits within context of SDS and LTDS

Phase 1: Strategic Direction and Long-Term Delivery

3.8 The first phase of work was to lay out our 2050 ambition, vision, aims and targets and to profile our proposed performance for the next 25-year period, including articulating the major trends we expect to see in the south east of England (e.g. the increasing impact from climate change and changing demographics with an aging and more vulnerable population). We used these to develop a set of challenges that we would need to address and how these challenges may play out against a range of plausible futures – and tested everything with customers and stakeholders. This work culminated in the creation of our 2023 Strategic Direction Statement.[37]

3.9 Drawing upon the improvement requirements driven by our WRMP for demand and supply measures, as well as profiled improvements in other measures, we created a set of targeted performance improvements for the 25-year period as a basis for our planning. Using the new Ofwat PR24 LTDS methodology, we created a set of future high and low scenarios around six areas of uncertainty, as summarised below.

Table 3.1: Future High and Low Scenarios

Scenario High	Scenario Low	Data Source	Key Metric
Population High - HPlan dataset	Population Low - ONS18 data set	Developed through Water Resources South East (**WRSE**)	Mld of additional demand
High Abstraction Reductions -	Low Abstraction Reductions	Developed through WRSE	Mld reduction in supply

[37] SEW, 2023, Strategic Direction Statement.

Scenario High	Scenario Low	Data Source	Key Metric
High climate change - Drought	Low climate change - Drought	Developed through WRSE	Mld reduction in supply
High climate change - extreme weather (RCP8.5)	Low climate change - extreme weather (RCP 2.6)	Independent modelling of climate impact from Government published UKCP18 probabilistic data Note: a RCP4.5 dataset was also modelled as part of this analysis	No of extreme events per AMP that drive customer interruptions, including: • Prolonged high temperatures • Hot and dry weather • Heavy rainfall • Heavy rainfall following hot spell • High winds • Extended cold period • Rapid thaw
Low technology advancement	High technology advancement	As per Ofwat methodology developed by SEW innovation team	Various – linked to benefits of various schemes that would be impacted by change in technology availability
Disorderly transition High	Disorderly transition Low	• Government legislation delays • Customer behaviour change • Landowner catchment management engagement	1) Mld of demand not mitigated 2) Catchments with raw water nitrate not mitigated by catchment management

Note: For the LTDS, we also ran a scenario that used a combination of WRSE scenarios that aligned with the best value WRMP24.

3.10 For the scenarios, we drew from analysis and regional data sets created as part of the WRSE activities that were the basis of our WRMP24, worked with the independent expert climate team in AtkinsRéalis on climate related extreme weather modelling and our internal innovation team for technology projections and their impact. For the disorderly transition scenario, we looked at key areas of our plans that were highly reliant on third parties and what would be the implications if the benefits from these activities were realised at a slower rate than expected.

3.11 We reviewed and defined the service consequences for each pathway, for each 5-year period, and this set the areas and size of performance challenges that the business planning process needed to address and what additional investment and activity would be required to continue to hit the profiled 25-year performance targets. Our analysis and outputs can be seen in our published Long Term Delivery Strategy.[38]

Phase 2: Current Performance and Improvements

3.12 Having identified our long-term performance profiles, 2050 targets and defined the extra performance requirements from the different future scenarios, we then needed to create a robust forecast for where the company performance would be for 2025 for each performance

[38] SEW, Long-Term Delivery Strategy 2025 to 2050.

commitment. This was based on published performance data from 2015/16 – 2022/23 and forecast data for the years 2023/24 and 2024/25.

3.13 For current performance issues, we reviewed and learned from real incidents, with independent reviews providing unbiased conclusions and recommendations for the largest ones. This allowed us to understand which elements of the events could be addressed through improved operational activities and which elements would require infrastructure investment. This contextualised our performance to better inform our starting point, identify localised constraints, underlying causes and also capture near misses where commitments and targets were met but conditions went outside of operational parameters and could indicate future problems.

3.14 We also reviewed how we could use our base expenditure, and continuous improvement to optimise our activities to drive performance improvements, and which performance commitments would see this benefit.

3.15 For enhancement spend, we looked to ensure that the need and scope drive improved service to customers, mitigate a new external risk and/or are driven by external changes via a statutory process. We also reviewed scope against likely maintenance requirements (as predicted by deterioration modelling) and removed these so the proposed schemes were not duplicating spend that overlaps with base capital funding and to ensure customers would not pay twice.

Phase 3: Needs, Solutions and Benefits

3.16 As part of the business planning process, water companies need to develop a number of investment projects via statutory frameworks administered by the EA (WRMP and the Water Industry National Environment Programme (**WINEP**)) and through engagement with the DWI to identify and agree investment requirements related to water quality and the Security and Emergency Measures Direction (**SEMD**)[39] which covers both physical and cyber security along with emergency response including the provision of alternative water and incident management. These are developed iteratively over time through engagement with stakeholders, including Ofwat.

3.17 The outputs from these frameworks and engagement are included in our PR24 Business Plan relatively unchanged, except to remove any base overlap spend, include appropriate overheads and efficiencies and also – in the case of large complex projects – subject to review against the Direct Procurement for Customers (**DPC**) tests and changing the delivery and funding approach if they meet the criteria.

3.18 For other investment needs and solution options, we worked regionally to address our current resilience issues and ensure we could meet the overarching ambition and objectives laid out in the 25-year Strategic Direction Statement.

3.19 Our tiered decision-making hierarchy prioritised non-infrastructure solution options, such as operational or nature-based solutions, before developing engineering solutions. Once the need for engineering solutions was established, we reviewed strategic, regional solutions and more localised options, intervention options at treatment works to maximise outputs and mitigate external risks such as flooding, pipelines to drive more interconnectivity to drive network flexibility, increased reservoir storage to increase the time between an issue occurring and customers running out of water, and technology options, such as “smart” meters and network sensors, to influence customer behaviour and identify and optimise our operational response to issues. Each solution was developed to an outline level to allow costs and benefits to be assigned.

3.20 In addition to the engagement used to develop our Strategic Direction Statement and carried out during the WRMP and WINEP statutory processes, we ran regional customer and stakeholder

[39] UK Government, December 2024, The Security and Emergency Measures (Water and Sewerage Undertakers and Water Supply Licensees) (Amendment and Revocation) Direction 2024. Note also UK Government, The Network and Information Systems Regulations 2018 which provides legal measures to protect essential services (including drinking water supply and distribution) by improving the security of the network and information systems that support the continuation of these services.

workshops and interviews to test regional investment priorities with affordability, particularly with respect to resilience investment.

3.21 Our customers told us that their **key priorities** are a **reliable, high quality water supply** followed by **leakage** and **affordability**. After these key priorities, customers next prioritise environmental aspects of our service. Our overall investment programme has been developed to meet these priorities and there are notable regional differences in our customers' and stakeholders' preferences that we have also taken into consideration in the development of our plans.

3.22 Specific feedback included:[40]

(a) There was general concern on leakage and wanting the level reduced. There was wide support on smart metering and smart network investment, as these were seen as proactive solutions that helped future-proof the system.

(b) Customers in the Western region want to continue to receive a reliable, high quality water supply, but their urgency for investment is less than for customers in our Kent and Sussex regions.

(c) Customers in our Sussex region recognise over-reliance on single sources of supply as a problem and welcome solutions to move water flexibly around the network, supported upgrades to key WTW, citing reducing the number of customers affected and also to address increasing population growth in the area. There was high support for increasing storage capacity in the region. This was all tested including bill impacts. Customers and stakeholders wanted reassurance that this improved resilience would be achieved with zero harm to the local environment and also expressed concerns about delays in getting these resilience solutions in place.

(d) Our Kent customers had concerns about increasing population and wanted Broad Oak reservoir delivered at pace to address future risk of supply demand deficits. Customers support a more flexible network grid, despite worries over potential disruption during construction, and the majority preferred faster investment even when considering bill impacts. When testing the speed of investment, customers prioritised making improvements at the WTW over 5 years. They supported the increase in service reservoir capacity but when tested against bill impacts, they wanted this phased over a longer time frame (and we duly spread it over three AMPs).

3.23 Overall, we received 71% customer and stakeholder acceptability of our final plan, which we believe is one of the highest levels in the South East region.

3.24 We used a corporate system to help us prioritise and support our choice of final solutions in our PR24 Business Plan. Our needs, proposed solutions and costs were inputted into the investment decision support tool [redacted] (which is our name for the industry leading decision support tool, [redacted]). Our costs for the proposed solutions were generated using the Unit Cost Database, inputted into the Cost Estimation module, and supplemented with bespoke costs from our Quantity Surveyors, where necessary.

3.25 We used the embedded Value Framework within the tool to assign Water Supply Interruption benefits to each option. Value measures have been tailored specifically to SEW's needs and include relative weightings between the different values gleaned from the customer engagement process. These models include Water Supply Interruptions, Unplanned Outage, Mains Repair, Leakage, Operational Carbon, Water Quality, and Financial and Reputational Risk.

3.26 Scenarios were then run to identify the optimal suite of investments, with the ability to prioritise over a range of metrics. Outputs were tested with subject matter experts across the business, including our operational leads, to check and validate the proposed solutions.

[40] SEW, PR24 Business Plan Main Document, page 18.

3.27 For our PR24 Business Plan submission, we have constrained the total levels of investment for 2025-2030 based on priority and affordability feedback from customers and stakeholders taken through the business planning process. The schemes that were chosen for this period therefore prioritised addressing existing supply interruption hotspots where customers have experienced recent impacts. The remaining 10 years of resilience investment contain schemes to address the remaining risk areas identified in the modelling, that have not yet materialised into issues for customers.

Engagement with Ofwat

3.28 Following submission of our PR24 Business Plan in October 2023, Ofwat raised a number of queries but there was limited opportunity for meaningful dialogue with the removal of the 'Initial Assessment of Plans' stage that was a valuable feature at PR19. Only a few of the queries raised by Ofwat related to our resilience schemes.

3.29 In July 2024, Ofwat published its PR24 DD. This included severe reductions to our proposed resilience and WRMP and WINEP investment programme and affected all the key elements of our resilience strategy.

3.30 Following receipt of the PR24 DD:

(a) We attended a meeting with Ofwat on 22 July 2024 at which they requested more information on our overall approach and strategy for resilience, as well as more detail on what we had done operationally to tackle issues prior to requesting infrastructure solutions.

(b) To ensure that we could satisfy Ofwat's requirements and to assist them in understanding our evidence, we requested – and attended – a further meeting with Ofwat's technical team on 1 August 2024. This was followed by a call with Ofwat on 6 August 2024.

(c) We also met Ofwat on 12 August 2024 to discuss how our sub-zonal schemes had been treated in the PR24 DD and specifically whether they should be treated as WRMP schemes (as the needs case for them was made in our WRMP24) or as resilience schemes (which is how they were assessed in the PR24 DD).

3.31 Pursuant to these meetings, we produced two additional documents, alongside further scheme data, to assist Ofwat in understanding our proposals. These documents are entitled 'Resilience Strategy'[41] and 'Operational Effectiveness'[42] and pulled together information from existing processes and strategies into centralised reports for Ofwat. They were submitted to Ofwat on 28 August 2024 as part of our Draft Determination Response (**DDR**).

3.32 We met with Ofwat to discuss our DDR on 9 October 2024.

Ofwat's PR24 FD

3.33 Ofwat published its PR24 FD on 19 December 2024.

3.34 Whilst Ofwat made significant changes between its PR24 DD and PR24 FD, the latter nonetheless rejected core elements of our resilience strategy and enhancement expenditure related to water security, undermining our path to delivering an improved service for our customers.

3.35 These issues – and their consequences for SEW – are addressed in Sections 4 to 7 of this Statement of Case.

41 SEW, August 2024, DDR – Resilience Strategy.
42 SEW, August 2024, DDR – Operational Effectiveness

Costs

Ofwat's methodology is technically flawed, too generic and its application results in unwarranted underfunding of efficient and necessary costs. These issues are further compounded when PCDs are attached to schemes with insufficient funding. The conditions to access the resilience contingent allowance are too restrictive and do not protect consumer interests.

The CMA should adopt the following approach:

(i) Adjust Ofwat's base costs models, post-modelling adjustments, and Cost Adjustment Claims (CACs) to reflect the expenditure proposals in our DDR, (subject to an uplift of £54m to reflect the higher mains renewals rate assumed in Ofwat's PR24 FD).

(ii) Adjust Ofwat's enhancement costs allowances, by uplifting funding for specified enhancement lines as set out in Table 4.2.

(iii) Set a frontier shift efficiency across base and enhancement costs of 0.5%, consistent with our PR24 Business Plan.

Overview

4.1 Our PR24 Business Plan was our most ambitious business plan ever, with stretching but deliverable targets for both costs and outcomes. The plan proposed a step-change in investment, with £1.98bn of requested wholesale total expenditure over 2025–30, in order to achieve higher levels of service, provide water security, reduce customer water supply interruptions (**WSI**) and enhance network resilience for our customers.

4.2 Ofwat's cost assessment framework at PR24 built on the framework developed in previous price controls, and involved:

(a) **Base costs**, which Ofwat describes as *"routine, year on year expenditure",*[43] assessed largely through econometric models;

(b) **Enhancement costs**, which Ofwat describes as "*generally where there is a permanent increase or step change in the current level of service to a new 'base' level and/or the provision to new customers of the current service level*",[44] assessed through a combination of benchmarking, shallow dives, and deep dives, depending on materiality of the cost, and whether econometric or unit cost benchmarking was feasible.

(i) Benchmarking was Ofwat's preferred method of assessment, and was used where most companies incurred similar costs and Ofwat could identify appropriate cost drivers. Where benchmarking was not appropriate, Ofwat used either "deep dives" or "shallow dives":

(A) Deep dives were used for requested costs greater than 0.5% of totex, or more than £10 million, and assessed the need for investment, best option for customers, cost efficiency and customer protection.

(B) Shallow dives were used for requested costs of less than 0.5% of totex and less than £10m, and involved Ofwat applying a company-specific cost

[43] Ofwat, February 2025, PR24 Final Determinations: Expenditure allowances, page 18.
[44] Ofwat, February 2025, PR24 Final Determinations: Expenditure allowances, page 95.

efficiency challenge based on the company's performance in Ofwat's enhancement benchmarking models.

4.3 However, PR24 also marked a significant shift away from the "outcome-focused framework" which applied at PR14 and PR19, where companies were granted totex allowances, and asked to achieve certain service quality and environmental *outcomes*, but without tying cost allowances to specific physical *outputs*. In previous AMPs, company management was therefore able to spend allowances flexibility to optimise investment programmes, and respond to emerging operational challenges.

4.4 In contrast, at PR24, Ofwat has introduced PCDs, meaning that funding must be used for the specified schemes, or companies face penalties. Companies therefore have significantly less flexibility to respond to emerging risks and challenges. Ofwat's focus on *"prevent[ing] customers from paying twice"*[45] has also led it to wrongly reject funding claims on the basis of supposed base or PR19 overlap, where there is in reality no such overlap. These points are discussed further in the Section 4 (Costs), Enhancement costs below (see paragraphs 4.37 to 4.82).

4.5 Ofwat's cost assessment resulted in us receiving an allowance of £1,862m. This was £280m lower than the expenditure that we identified in our plan (both figures after application of Ofwat's RPEs and Frontier shift). After reviewing Ofwat's analysis, we have reached the conclusion that Ofwat under-funded our efficient costs due to a series of weaknesses and flaws in its assessment framework. In relation to **base costs**:

(a) Ofwat's models are flawed and undermine SEW's efficient costs by failing to accurately reflect industry-wide cost pressures relating to topography, population growth and water treatment complexity.

(b) Ofwat's post-modelling adjustments methodology underfunds SEW's efficient costs in relation to water mains replacement and meter renewals.

(c) Ofwat's approach to CACs for WTW-level economies of scale and network reinforcement materially underestimates the adjustment needed for SEW.

4.6 In relation to **enhancement costs**:

(a) Ofwat has misunderstood the need for investment in its deep dives: this means Ofwat has disallowed significant schemes through an inappropriate assessment of the need for investment. Ofwat's comments on our schemes demonstrate that it has not carefully considered the evidence and therefore it has disallowed needed and efficient expenditure.

(b) Ofwat's method to assess cost efficiency is arbitrary and ignores compelling evidence: this means Ofwat has not allowed efficient costs to deliver our schemes. Even where we put forward strong third party evidence, Ofwat has ignored this evidence. This results in cost allowances that are not realistic.

(c) Ofwat's assessment of PR19 and base overlap is incorrect: this means Ofwat has wrongly disallowed PR24 enhancements costs on the basis of an overlap with previous funding. This means that Ofwat is retrospectively introducing output-based requirements that did not exist at PR19. Ofwat's assessment of base overlap is also incorrect and not transparent.

(d) The £50m contingent allowance is onerous, unpredictable and disproportionate, can only be applied for mid-way through the AMP and in any case is too small to address our significant enhancement costs gap of £229.9m. The solution to the problems with Ofwat's costs assessment is to set ex ante allowances which fully fund our efficient costs.

[45] Ofwat, February 2025, PR24 Final Determinations: Expenditure allowances, page 9.

4.7 In relation to **frontier shift**, Ofwat's frontier shift assumption of 1.0% ignores the basic intuition and consistent evidence that the water sector is unable to significantly outperform the overall UK economy in relation to productivity gains.

4.8 Ofwat's cost allowances significantly underfund our efficient costs and mean that in practice we will not be able to deliver the performance that our customers want. This is particularly true in relation to water supply interruptions, where we face a combination of challenges which is unique compared to the rest of the industry, as explained in Section 2 (Our story), and Ofwat's cuts to key schemes will impede delivery of our resilience strategy. An FD which leads to this outcome is inconsistent with Ofwat's statutory duties.[46]

Base

Introduction

4.9 Approximately £1.2bn of our PR24 Business Plan related to wholesale base expenditure (**botex**), covering operating expenditure and capital maintenance. In developing our plan, we set out the need for increased levels of expenditure on base activities to operate, maintain and replace a larger and deteriorating asset base, while delivering higher levels of service and resilience. An appropriate level of base expenditure influences resilience and water security for both infrastructure and non-infrastructure assets and will entail:

(a) Regular maintenance through cleaning and rehabilitation of our 250+ boreholes (which supply most of our region's drinking water) prevents deterioration of these vital water sources.

(b) Ensuring WTWs operate at full capacity and to the required water quality standards, through routine maintenance and refurbishments are important for maintaining customer supplies.

(c) Maintaining and renewing the network of pipes and associated apparatus, such as valves, that connects our water sources to WTWs and our distribution network, prevents unnecessary water losses which is vital in water-scarce regions like the south east and reduces the number of mains failures which can impact our customers.

(d) Protecting service reservoirs through a robust inspection, cleaning and remedial programme provides strategic storage that mitigates the risk of supply interruptions.

(e) Maintaining pumping stations ensures that water keeps flowing, within our distribution network for our customers.

(f) Supporting other essential management and general activities such as our meter renewals, fleet and IT systems.

4.10 Without adequate base funding, these assets risk gradual deterioration, leading to increased risk of asset failure. Ultimately, this asset failure would lead to reduced water availability (particularly from our boreholes), more frequent water supply interruptions and would compromise our ability to meet demand, particularly during peak periods.

4.11 Our plan reflects the minimum investment needed to maintain these critical assets, while delivering higher service levels and enhanced resilience for our customers.

4.12 We built high levels of efficiency challenge and stretch into our plan with a view to minimising bill impacts and delivering the greatest value for money for customers. Specifically, we applied efficiency savings of 1.9% per annum to our base expenditure (prior to real price effects, **RPEs**). This comprised a frontier shift of 0.5% p.a., catch-up efficiency of 0.3% p.a. and a further stretch

[46] See Annex B (Legal and regulatory framework). In this context, Ofwat's consumer duty, resilience objective and growth duty are particularly relevant.

challenge of 1.1% p.a.[47] All the figures quoted in this section are post adjustments and before frontier shift.

4.13 Ofwat's DD proposed material cuts to our PR24 Business Plan, which would have significantly impacted our resilience strategy and water security in the south east of England. Ofwat subsequently took steps to reduce the gap at FD, and recognised that SEW requires a step-increase in base cost allowances in PR24 relative to PR19. However, there remains a 6% gap (resulting in a shortfall of £70m) between Ofwat's assessment of our base costs, and the level that we requested in our PR24 Business Plan. Critically, while Ofwat made cuts to our base funding request, it also placed considerably higher (and unevidenced) expectations of what can be funded from base expenditure, leading to disallowed enhancement cost requests and a lack of funding to efficiently deliver customer outcomes.

4.14 On the base cost models, building on the PR19 consultation process, Ofwat made efforts to engage with the industry at an earlier stage than in previous reviews with a view to giving companies early sight of how base costs would be set. However, despite our representations, Ofwat's final methodology still has several limitations and has resulted in a cost allowance for SEW that underestimates our efficient cost requirements for AMP8 for the following reasons.

(a) Ofwat's models underfund our wholesale base requirements due to issues with Ofwat's methodology, including a failure to adequately reflect SEW-specific factors and the expenditure needed to deliver our PR24 Business Plan.

(b) Ofwat did not present evidence to support its catch-up efficiency challenge (Upper Quartile (**UQ**) benchmark) at the FD, merely noting that it was aligned with regulatory precedent. Applying the same analysis as was applied by the CMA at PR19 to Ofwat's PR24 models, reveals the UQ to be the most stringent benchmark that could be supported by the quality of the models.[48] In other words, the UQ benchmark is a challenging but achievable benchmark when considered in isolation. However, Ofwat has applied several implicit and explicit efficiency challenges on top that risk the deliverability of our PR24 Business Plan, including the frontier shift challenge (as outlined in paragraphs 4.83 to 4.96 below), the application of stretching PCLs (see Section 5 (Outcomes)) and the reallocation of enhancement funding to base (see paragraph 4.77). If a UQ benchmark is to be retained, such implicit and explicit efficiency challenges require correction.

(c) Finally, Ofwat has not adequately funded us to deliver our mains replacement and meter renewal programmes,[49] yet has exposed us to financial penalties if we do not deliver them. The introduction of PCDs severely inhibits our flexibility to deliver our maintenance programme by exposing us to financial penalties if we need to re-prioritise maintenance activity away from mains replacement (for example) towards non-infrastructure maintenance. If we deliver these programmes within the base cost allowances (if it is feasible at all), it would necessarily leave us significantly underfunded (at a level lower than AMP7) to deliver other essential maintenance activities. This would affect work across our infrastructure, including WTW and borehole maintenance, pumping stations operations, control system upgrades, service reservoir repairs and critical equipment replacement, which would compromise our ability to maintain service levels and network reliability for our consumers. This erosion of base expenditure is exacerbated by Ofwat asking us to deliver more through our base allowances by setting stretching service targets (see Section 5 (Outcomes) below) and reallocating a significant proportion of our enhancement expenditure requests into base (see Section 4 (Costs), Enhancement costs below).

4.15 In the remainder of this section, we outline the flaws in Ofwat's methodology that cause this substantial underfunding, and the remedies the CMA should implement to resolve these issues.

[47] SEW, 2023, PR24 Business Plan Main Document, pages 141 and 142.
[48] Oxera, March 2025, Wholesale base expenditure modelling, pages 13 to 15.
[49] Oxera, March 2025, Base cost adjustments and cost adjustment claims, pages 4 to 10 and pages 19 to 22.

Flaws in Ofwat's base cost methodology

4.16 In determining cost allowances for AMP8, Ofwat has primarily assessed botex using a set of econometric models (with 24 econometric models for the water price controls).[50] Building on these botex models, Ofwat made several adjustments in an effort to impose efficiency challenges and account for future changes in operating environment, including the following.[51]

(a) Efficiency challenges: Ofwat imposed two top-down efficiency challenges to reflect catch-up efficiency and frontier shift. For the former, Ofwat set the challenge at the upper-quartile (**UQ**) performance across the sector. For the latter, Ofwat set a challenge of 1% p.a. (see paragraphs 4.83 to 4.96 below, which address frontier shift).

(b) Post-modelling adjustments: Ofwat acknowledged that the industry required a step-change in expenditure relating to industry-wide challenges in AMP8 that were not adequately captured in the botex models, including the need for increased mains replacement, meter renewal and network reinforcement activity.

(c) Cost adjustment claims: Ofwat recognises that its cost models may not adequately capture all drivers of expenditure, particularly if such drivers are only relevant for a subset of the industry, resulting in a biased assessment of some companies' efficient cost requirements. As such, Ofwat has made additional allowances through the CAC process to correct for these biases.

4.17 Ofwat's decisions in each of these steps – in isolation and as a collective – materially underfund us to deliver on our obligations. These decisions are discussed in detail below alongside robust remedies to address them, with further details provided in two reports produced for SEW by Oxera to support our Statement of Case: the Base Costs Modelling Report and the Post-Modelling and CACs Report. Materially underfunding our efficient base costs means that we will be exposed to a disproportionate risk of overspending in order to meet Ofwat's service targets in the ODI package.

Base cost models

4.18 Ofwat's base cost models are necessarily imperfect simplifications of water companies' operations. The models capture some differences in companies' characteristics (i.e. scale, density, topography, treatment complexity) through imperfect proxy variables, and do not explicitly capture several industry-wide drivers of expenditure, including maintenance activity, network capacity and service performance, or local, company-specific cost pressures. As such, base cost modelling may be able to provide a reasonable starting point for assessing companies' efficient cost requirements (if the models are sufficiently robust). However, additional adjustments are required to account for step-changes in activity or performance and company-specific factors.[52] While Ofwat has introduced adjustments to account for these issues in isolated cases, it has not done so sufficiently across all areas.[53]

4.19 On the base cost models themselves, we recommended a number of changes in our DDR that would improve Ofwat's models from an operational and statistical perspective. Our proposed

---

50 Certain unmodelled costs are assessed through bespoke methods.

51 Note that Ofwat made adjustments beyond those listed here, such as the use of cost driver forecast data and adjustments for RPEs.

52 For example, Ofwat argues that its density drivers implicitly capture the costs associated with differences in regional wages. Based on how Ofwat models the relationship between costs and density, this relies on the assumption that sparse and densely populated regions overlap with regions with relatively high wages such that the corresponding cost effect would be picked up through correlation. While this relationship may hold true for some or on average, it may not work for all companies. **SEW operates in a region that is 'averagely' dense, under Ofwat's density measures, yet has the one of the highest average wages in the country. Therefore, density may not fully reflect the costs associated with regional wages for SEW and similarly affected companies**. This is one example of where the use of imperfect proxy variables in models may not accurately capture certain companies' cost pressures, such that post-modelling adjustments and cost adjustment claims are required.

53 See Oxera, March 2025, Base cost adjustments and cost adjustment claims, page 2.

models capture industry-wide cost pressures relating to topography, population growth and water treatment complexity better than Ofwat's models, as follows.[54]

(a) Topography: The topography of a water company's supply area is an important costs driver because operating in hillier areas means water must be pumped greater distances, which increases pump maintenance and power costs. Ofwat's models suffer from omitted variable bias (**OVB**) in relation to topography, and Ofwat's approach to aggregating across models does not eliminate this bias. Correcting for this bias leads to an improvement in the statistical quality of the models and increase in allowances for companies like us operating in regions involving complex topography, indicating that Ofwat's models insufficiently capture this characteristic. The specific remedy that we propose is to include both Average Pumping Head (**APH**) and Booster Pumping Stations (**BPS**) in the same model, rather than half of the models controlling for one, and the other half controlling for the other. As the Base Costs Modelling Report explains further, including both APH and BPS in the same model results in improvement in the model's statistical quality.

(b) Population growth: Ofwat's treated water distribution (**TWD**) models do not sufficiently account for costs associated with population growth, such as network reinforcement (which includes for example upsizing mains). This results in a biased assessment of companies' expenditure requirements if they operate in high-growth regions like ours. The remedy is to include connected properties as a scale driver in half of the TWD models, rather than only length of network, per Ofwat's approach. As explained in the Base Costs Modelling Report, this change would better capture the impacts of population growth.

(c) Treatment complexity: This is a costs driver because raw water quality varies significantly across the UK and from source to source, from areas with water sources needing limited treatment (e.g. chalk stream sources may need only chlorination) to areas with river sources needing several treatment steps. Ofwat's weighted average complexity variable (**WAC**), which is a weighted proportion variable, is operationally unintuitive[55] and performs poorly from a statistical perspective relative to simple, robust alternatives. The remedy is to model WAC in levels rather than logarithms, which as explained in the Base Costs Modelling Report, leads to a clear improvement in the statistical quality of the models.

4.20 By better capturing these industry-wide cost pressures, the models account much better for the cost pressures that SEW faces as a company operating in a region of high population growth[56] and challenging topography.[57] We therefore ask the CMA to adopt our improved models in its cost assessment to provide a more robust assessment of our baseline expenditure requirements, before considering post-modelling adjustments and cost adjustment claims that reflect forward-looking challenges and our unique operating environment, which are not adequately reflected in the baseline.

4.21 The effect of our modifications would be to increase in our base allowance by c. £44m relative to the allowance that Ofwat made in its FD.

Sector-wide post modelling adjustments

4.22 Ofwat acknowledged that its base models do not appropriately fund companies for the step-changes in the operating environment expected in AMP8. It therefore applied sector-wide adjustments for (i) network reinforcement; (ii) water mains replacement; (iii) meter renewals; (iv)

[54] These are explained in more detail in Oxera, March 2025, Wholesale base expenditure modelling.

[55] For example, under Ofwat's modelling approach, a company that increases its WAC from 1 (all water treated at simple treatment works) to 2 (all water treated at complexity band 1) has the same increase in predicted costs as a company that increases its WAC from 3 (all water treated in complexity band 2) to 6 (all water treated in complexity band 5), which is unintuitive.

[56] We are anticipating the highest growth in connected properties in the industry over AMP8, and have experienced the fourth highest increase in connected properties on an outturn basis.

[57] Ofwat uses two variables to measure network topography: average pumping head (APH) and booster pumping stations per length of network (BPS). We have the second highest APH in the industry and are above the industry median on BPS.

GHG emissions; (v) energy prices in water, which were first consulted at the DD stage. In general, Ofwat constructed these post-modelling adjustments as follows.

(a) Implicit allowance: Ofwat determined what level of activity is implicitly funded through the botex models, typically by examining what the industry has delivered on average during the modelling period (2012–24) or what companies had set out in their business plans at PR19.

(b) Unit cost: Ofwat constructed an 'efficient' unit cost for the activity, based on either the industry median or what companies have requested (plus efficiency challenges in some cases).

(c) Constructing the adjustment: Ofwat calculated the adjustment as the difference between what Ofwat expected companies to deliver and what is implicitly funded by the models, multiplied by the efficient unit cost.

4.23 These adjustments are necessary given the limitations of the base models and Ofwat's approach to modelling companies' business plan data. However, for two post-modelling adjustments – mains renewal and network reinforcement – Ofwat's methodology (specifically the first two steps of implicit allowance and unit costs) materially underestimates the efficient expenditure we require to meet the challenges of AMP8, for the following reasons.

4.24 First, Ofwat's methodology relies on assumptions that generally overestimate the level of activity that is implicitly funded in the models. Given that Ofwat's base cost models do not include such activities (e.g. mains replacement) explicitly and companies' cost performance are benchmarked over the last five years of outturn data (currently 2020–24), the models implicitly fund companies for the activity that occurred in that period, either by the industry average or by the benchmark companies. In contrast, Ofwat's post-modelling adjustments for water mains renewals and meter renewals[58] are based on activity levels over the last thirteen years.[59] As the level of activity has generally declined over time,[60] extending the calculation period beyond the last five years materially overestimates what is implicitly funded.

4.25 Ofwat's decision to determine the implicit allowance based on the full modelling period is inconsistent with its argument that benchmarking over the last five years *"helps to ensure the base expenditure allowances reflect more recent cost pressures"*.[61] That is, Ofwat argued that recent cost pressures are captured by restricting the benchmarking period to the last five years. It naturally follows that the benchmarking period should be used to determine what is implicitly funded through the models.

4.26 Second, Ofwat has wrongly penalised certain companies – including SEW – by removing allowances where it argues companies did not deliver the activities set out in their PR19 business plans. This is an arbitrary, asymmetric and retrospective regulatory intervention that is inconsistent with the principles of the PR19 price control, given that the totex regime was supposed to enable flexibility, where companies were encouraged to optimise delivery with their allowances (and have subsequently overspent). The schemes assessed in the PR19 process formed the basis on which Ofwat set companies' cost allowances, but Ofwat encouraged companies to make their business plans adaptive to performance and other factors which could change in the outturn.

4.27 Finally, Ofwat's one-size-fits-all approach to constructing an efficient unit cost attributes regional and other differences to inefficiency. Ofwat acknowledges that unit costs may differ across England and Wales through its adjustment to Thames Water's mains replacement unit cost, but

[58] See Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances - Base cost modelling decision appendix, page 27.

[59] Oxera, March 2025, Base cost adjustments and cost adjustment claims, pages 7 and 20.

[60] The declining activity over time could be explained, at least in part, by the overly stretching targets on cost and performance at PR19.

[61] Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances - Base cost modelling decision appendix, page 27.

it does not account for characteristics that may cause unit rates to vary in other parts of the country.

(a) Our proposed unit costs for **mains replacement** are based on historical outturn costs over a five-year period.

(i) First, our unit costs are higher than the median due to regional differences in the south east of England. We operate in a region with congested roads which therefore result in stringent highways permitting processes, costs and requirements. Regional differences can be observed in Ofwat's unit cost model dataset in which Southern Water and Thames Water both have a higher-than-median unit cost. It can be seen that the lower unit costs for adjacent water companies such as Affinity Water and SES are linked to Ofwat's DD unit rate rather than actual costs.

(ii) Second, we operate in a region with a high density of categorised environmentally sensitive areas (Sites of Special Scientific Interest, **SSSI**) which inherently require increased mitigation when planning and undertaking schemes.

(iii) Third, compensation costs related to use of land, loss of business, etc. are higher in the south east as an affluent area and the public are more inclined to seek higher compensation.

(iv) Fourth, wages in the south east of England are systematically higher than average across the country, and SEW is not immune from local labour market pressures (i.e. we are largely 'price takers' with respect to labour).

(b) Our proposed unit costs for **meter renewals** (£167) are efficient, and a number of meter renewals will cost significantly more than this unit rate. Ofwat's unit cost assessment is based on an infeasibly wide range of proposed unit costs (from £50.96 to £261.91), which suggests costs are being reported on an inconsistent basis. Unit costs from HDD at £50.96 per meter should have been excluded from the benchmark as an outlier.

4.28 Unless top-down models are developed that account for regional differences robustly (which would likely lead to a more reasonable range in companies' efficiency differences), or it is demonstrated that our proposed unit costs are inefficient, the CMA should accept our unit cost proposals in full as these have been market-tested.

4.29 These issues require correcting for all of Ofwat's post-modelling adjustments and are most material for Ofwat's adjustment for mains replacement activity. Specifically, correcting the issues for mains replacement leads to an increase in the value of the adjustment from c. £29m to c. £101m, as follows.

(a) Implicit allowance: Ofwat assumes that the models implicitly fund companies to deliver c. 0.3% p.a. mains replacement activity, while the true implicitly funded rate is c. 0.15% p.a., when the implicit allowance is calculated based on the industry average renewal rate from the last five years, consistent with the benchmarking period.

(b) Target activity: Compared to our target to deliver 0.43% p.a. of mains replacement activity through base expenditure, Ofwat assumes that c. 0.13% p.a. of mains replacement activity is unfunded through the models. In reality, c. 0.28% p.a. of mains replacement activity is unfunded. That is, the unfunded rate of activity is more than double what Ofwat assumes.

(c) Unit cost: Ofwat assumes that £300/m represents an efficient, deliverable unit cost for SEW, while our own analysis suggests a unit cost of £[redacted]. Ofwat's assumptions impose an unjustified c. 35% challenge to our proposals.

4.30 Once the issues relating to the implicit allowance, PR19 under-delivery adjustment and unit cost analysis are addressed for the three most material post-modelling adjustments,[62] the total value

[62] These adjustments relate to mains replacement, meter renewals and network reinforcement.

of these adjustments increases from £90m to £187m. Put another way, Ofwat's FD materially underfunds us to deliver the step-change in activity required in AMP8. As noted above (paragraph 4.14(c)), the introduction of PCDs alongside this underfunding would either lead to unjustified PCD penalties or would lead to a material and unjustified challenge to our other maintenance plans, such as borehole maintenance, as these other programmes of activity would have to be reduced to accommodate delivery to meet the PCD. These elements both individually and in combination with other stretching elements of Ofwat's PR24 FD package, severely inhibit our ability to provide a resilient service to our customers.

Cost adjustment claims (CACs)

4.31 Ofwat acknowledges that regional or operational characteristics for specific companies may not be adequately reflected in its base cost models. To address this, Ofwat allows companies to submit CACs alongside their business plans, so that it can make suitable company specific post-modelling adjustments where these are justified.

4.32 As part of our October 2023 PR24 Business Plan submission, we submitted three CACs for factors that were not captured by the base models developed as part of Ofwat's modelling consultation. These covered: (i) network reinforcement; (ii) economies of scale at WTWs; and (iii) meter renewal activity. We subsequently withdrew our meter renewal CAC as Ofwat proposed a sector-wide mechanism at DD stage.

4.33 In the FD, Ofwat has made the following decisions with respect to the WTW-level economies of scale and network reinforcement CACs.

(a) **WTW-level economies of scale:** Ofwat's wholesale water base models did not explicitly account for WTW size, despite WTW-level economies of scale being a material driver of expenditure (larger WTWs benefit from economies of scale regarding operational costs, such as energy, chemicals and maintenance visits). Indeed, Ofwat controls for sewage treatment work (STW) size in all of its equivalent wholesale wastewater models. This leads to a biased assessment of efficient cost requirements for companies that operate a large number of small WTWs, like SEW, and this bias needs to be corrected through a CAC. Ofwat accepted the need for an adjustment to address this, at the FD, but it has used alternative top-down models[63] to reduce the value of the claim from £25.1m to £14.3m. However, Ofwat's analysis was partial in scope, as it focused only on the water resources plus (**WRP**) models and omitted the impact on wholesale water (**WW**) models entirely. Simply extending Ofwat's analysis to include the WW models increases the CAC value from £14.3m to c. £24m, which is aligned with our original request. Moreover, all of the alternative models perform poorly from a statistical perspective, such that the estimated CAC value is intrinsically uncertain. More robust methods, which utilise both bottom-up modelling and top-down modelling, demonstrate that the original request of £25.1m is a conservative estimate and sits within a reasonable range, such that further challenges to this adjustment based on low-quality and partial evidence result in material underfunding. The CMA should therefore allow the full extent of our CAC, as set out in our PR24 Business Plan.[64]

(b) **Network reinforcement:** We proposed a CAC to address the additional network reinforcement costs we face by virtue of operating in an area with high forecast population growth relative to the industry as a whole, i.e. the costs of upgrading or adding network assets such as WTW, pumping stations and mains to supply new customers. Ofwat assessed our proposed CAC through the sector-wide network reinforcement adjustment. While we welcome Ofwat's acceptance of the need for an adjustment, Ofwat's adjustment suffers from the same limitations as its other post-modelling adjustment, i.e. Ofwat overestimated the extent to which network reinforcement is implicitly funded and underestimated the efficient unit costs required to deliver our network reinforcement programme. The CMA should reinstate our proposed network reinforcement CAC

63 These alternative models control for WTW size as an additional cost driver.

64 We note that the size of our WTWs has been a longstanding issue for which we have never received additional funding. That is, we have been historically underfunded on account of this issue, which compounds the challenge that Ofwat has applied.

methodology, which would result in an additional base costs allowance of £10.2m, as further described in the Post-Modelling and CACs Report.[65]

Remedy

4.34 Table 4.1 below summarises the combined effect of the flaws in Ofwat's approach to setting our wholesale base expenditure requirements.

Table 4.1: Overview of base cost corrections according to Oxera's modelling

	Ofwat FD	Corrected
Wholesale base cost models[1]	798	843
Post-modelling adjustments[2]	121	218
Cost adjustment claims	14	26
Unmodelled base costs[1]	238	238
Total base allowance	1,171	1,325

Note: All figures in 2022/23 prices.[1] We have not made any adjustments to the choice of benchmark, RPEs, unmodelled base costs or the energy price and greenhouse gas (GHG) emissions post-modelling adjustments.[2] In line with Ofwat's FD, we have classed network reinforcement as a post-modelling adjustment in this table.

4.35 Table 4.1 above shows the outcome of corrections applied to FD base cost models by Oxera's modelling, which results in additional base totex allowances of +£154m. These figures show that the base totex submissions included in our DDR, totalling £1,246m, were both efficient and highly ambitious (noting that our DDR was based on a lower level of mains renewals).

4.36 The CMA should adjust Ofwat's base costs models, post-modelling adjustments, and CACs to address the shortcomings identified in this section. At a minimum, base allowances should fully fund the amount our DDR submission of £1,246m, plus an uplift of £54m to a total of £1,300m (+£129m vs the PR24 FD), to reflect the fact that Ofwat's FD implies a mains replacement rate of 0.43%, compared to our DDR assumption of 0.28%.[66] This remains ambitious and efficient compared to costs calculated based on Oxera's improved modelling in Table 4.1 above.

Enhancement costs

Introduction

4.37 In our DDR, we proposed enhancement costs funding of £794.9m.[67] In the FD Ofwat assessed £770m[68] of our request, of which it allowed £576.7m[69] including the £50m resilience contingent fund or £526.7m without the £50m resilience contingent fund.[70] All the figures quoted in this section are post adjustments and before frontier shift.[71] Our challenge to the frontier shift is discussed in paragraphs 4.83 to 4.96 below. Although Ofwat's FD allowed a significant increase to our enhancement funding compared to historic levels, we are still faced with a significant and material funding gap of £229.9m, particularly in the areas of spend that impact water security. This section explains how Ofwat's approach to assessing enhancement costs prevents us

65 Oxera, March 2025, Base cost adjustments and cost adjustment claims.
66 Our overall base expenditure request of £1,300m is higher than our request of £1,246m at the DD response. This is largely driven by the impact of the 2023/24 data on the base cost models and post-modelling adjustments, which was not fully reflected in our DD response, together with the £54m uplift of the higher mains renewals rate assumed by the PR24D.
67 SEW, DDR Cost Assessment - Summary, Page 4.
68 The difference between the requested enhancement costs at DDR and the amount assessed at FD comes from a re-allocation of metering costs to base and small adjustments to data tables.
69 Ofwat, December 2024, PR24 Enhancement aggregator model 2, sheet "Water post adj".
70 Ofwat, December 2024, PR24 Enhancement aggregator model 2, sheet "Water post adj".
71 Ofwat, December 2024, PR24 Enhancement aggregator model 2, sheet "Water post adj".

incurring efficient expenditure and therefore stops us delivering a resilient service for customers and undermines our ability to carry out our statutory functions.

4.38 As discussed in Section 3 (Our PR24 plan for resilience), our PR24 Business Plan was developed in response to significant challenges posed by the reality of running our business. The expenditure we included in our enhancement programme is urgently needed to deliver better services and water security for customers. We submitted a highly ambitious plan and we were then asked by Ofwat to find further stretching project deferrals and savings in the DD. We implemented this further stretch as part of our DDR, meaning our final PR24 plan as presented in our DDR was already stripped to the minimum required level prior to the FD. Every scheme included in our DDR has been carefully considered, including the need for the investment, the timing (e.g. whether it needs to be completed in 2025-2030, or later periods), full optioneering and cost benefit analysis to ensure that each scheme provides the best option for customers at efficient costs.

4.39 In contrast to PR14 and PR19, we do not have flexibility to adjust our overall programme to the level of spend allowed by Ofwat – or to respond effectively to emerging risks – as Ofwat has expanded its use of price control deliverables (**PCDs**), which clawback funding from companies if specified outputs are not delivered (or in some cases, not delivered on time). 78%[72] of our enhancement programme is covered by PCDs meaning that we cannot substitute one scheme for another, or reprioritise delivery of schemes to reflect changes in operational circumstances. In addition, this means that in areas where Ofwat has not allowed sufficient funding, but has introduced a PCD, we still need to deliver every scheme. Altogether, the PR24 FD restricts our ability to reprioritise our investment programme to respond to emerging challenges, in the way that has been necessary in AMP7 to respond to unforeseen events such as shifts in demand due to Covid-19, and extreme weather.

4.40 Overall, the FD leaves SEW materially underfunded to deliver the level of service that our customers expect, and to restore the resilience of our network (and is therefore inconsistent with Ofwat's resilience duty). We therefore request that the CMA fully funds all of our proposed efficient expenditure so we can deliver resilient services for customers.

4.41 This section is structured as follows:

(a) First, we provide an overview of our enhancement programme, the key drivers and the funding gaps.

(b) Second, we describe why the FD's contingent allowance is not sufficient to address our enhancement funding gap.

(c) Third, we outline Ofwat's methodology and the fundamental issues with the methodology that prevent us from delivering the level of service our customers expect.

(d) Fourth, we set out the remedies we are seeking from the CMA.

4.42 Annex G (Enhancement costs) provides detailed submissions on each enhancement line, with further information on how our proposals meet the relevant criteria, and why Ofwat's assessment in the PR24 FD is wrong.

Our enhancement programme: overview, key drivers and material gaps

4.43 As explained in Section 3 (Our PR24 plan for resilience), our enhancement programme was developed by bringing together all statutory and customer drivers into a single, optimised and prioritised programme. Our programme covers three key overarching drivers: resilience and security, environment, and water security. Table 4.2 below shows the relevant enhancement lines that Ofwat has adopted to compare enhancement funding requests across the industry, the specific schemes that are included in each enhancement line, the costs proposed in our DDR (as per Ofwat's allocation), the FD allowance, and the resulting funding gap. In the gap column we

[72] This means 78% of the allowed expenditure without the £50m contingent fund. If we were to receive funding under the £50m contingent fund, we would expect this to be covered by a PCD but we have excluded this for now.

have highlighted the schemes that we are asking the CMA to re-consider in blue. We have excluded the following schemes:

(a) Schemes with a cost gap below £1m, in order that the CMA can focus on the material gaps;

(b) Schemes where Ofwat's allowance exceeded our DDR request – this is only relevant for two lines (supply and strategic resource options) as metering needs to be assessed together with base allowances. We understand Ofwat has provided very ambitious companies some upside, in line with standard practice to create incentives and recognising the value that our ambitious efficiency generates (via benchmarking) for customers across the country. We also note that: (i) the amount of "additional" funding Ofwat has allowed for these lines compared to our request is insignificant when compared to the degree to which we have been underfunded on other requests; and (ii) if we do manage to underspend the allowances for these schemes (which is by no means guaranteed) our strong efficiency performance will then be shared with customers.

4.44 We have included all other schemes as we need to deliver our full enhancement programme to improve the resilience of our services for customers and as a result of PCDs there is limited flexibility at PR24 to optimise our programme across different enhancement lines or schemes.

4.45 With regard to water efficiency initiatives, we have continued to optimise our programme and have revised our costs from £53.7m to £40.2m and this has been reflected in our calculation on the remaining gap.

Table 4.2: Overview of enhancement lines and cost gap (excluding £50m contingency allowance)[73] (all figures are pre-frontier shift)

Key driver	Ofwat enhancement lines	Schemes	SEW enhancement funding assessed by Ofwat	Ofwat FD allowance	Gap[74]
Resilience and security	Resilience – Interconnectors	Resilience interconnectors, including supply interconnectors assessed as resilience	128.8	90.4	38.4
	Resilience	WTW Bewl	26.7	0	26.7
		WTW Tonbridge and Pembury	8.0	8.0	0
		WTW Barcombe	45.4	45.4	0
		Service Reservoir capacity increases	34.0	25	9

[73] The table provides the cost we requested for each scheme, the allowance Ofwat has included in the FD and the resulting gap without Ofwat's £50m contingency allowance.

[74] All costs are rounded to one decimal place.

Key driver	Ofwat enhancement lines	Schemes	SEW enhancement funding assessed by Ofwat	Ofwat FD allowance	Gap[74]
		SRN WTW upgrade (River Medway scheme)	15.5	8.7	6.8
		Smart Network	36.8[75]	0	36.8
	Security	Cyber	29.3	27.9	1.5
		SEMD	12.1	10.9	1.2
Environment (WINEP)	Raw water deterioration		64.1	61.4	2.6
	Investigations		58.9	47.2	11.7
	Drinking water protected areas		18.9	17.0	1.9
	Water Framework Directive		8.1	7.4	0.7
	Biodiversity and conservation		5.2	4.7	0.5
	Discharge monitoring		2.4	2.4	0
	25-year environment plan		2.3	2.1	0.2
	Invasive non-native species		0.8	0.7	0.1
	Eels/fish passes		0.2	0.1	0
	Net zero		12.6	0	12.6
Water security	Leakage	Mains replacement	41.0	16.1	24.9[76]
		Other Leakage activity	43.1	18.8	24.3
		Deep dive costs reallocated from Smart Network	11.3	0	11.3
	Demand (Water efficiency initiatives)		53.7 (Revised cost estimate to 40.2)[77]	24.1	16.1 (based on revised cost estimate)
	Supply		2.9	4.0	-1.1
	Metering		20.2	25.2	-5.0
	Strategic resource options		63.5	72.3	-8.8

75 Ofwat re-allocated £11.3m of the smart network costs to "other leakage activity". As we do not agree with this re-allocation we have included this in smart network.

76 The key issues with regard to the mains replacement cost gap are discussed in the base cost section and are not covered in this section. For the avoidance of doubt, the "gap" figure in this row is not counted towards the total gap of £229.9m.

77 Following the FD, we have continued to optimise our plan and revised our cost estimate to £40.2m.

Key driver	Ofwat enhancement lines	Schemes	SEW enhancement funding assessed by Ofwat	Ofwat FD allowance	Gap[74]
	Lead		24.3	6.9	17.4
Total			**770 (based on original cost estimate for water efficiency)**	**526.7**	**229.9**

4.46 In addition to the gap shown in the table above, updated DWI guidance published in August 2024 requires us to deliver an additional scheme to address poly fluoroalkyl substances (PFAS) (Forstal WTW at a cost of £4.8m) and conduct further 5 catchment studies (at a total cost of £4.2m). Ofwat was not able to assess these requirements in the FD as they were published too late in the process. While Ofwat has introduced an uncertainty mechanism for notices published post 20 December 2024, these requirements were published too early to be considered for the uncertainty mechanism but too late to be considered in the PR24 FD. We therefore ask the CMA to allow £9.1m of funding to deliver these schemes.

Why Ofwat's contingent allowance for resilience does not address our funding gap

4.47 Ofwat included a £50m contingent allowance in the FD. The £50m is included in our bill impact and Ofwat reported the gap between our requested and allowed funding as net of the £50m.

4.48 In its FD, Ofwat stated that: "*There is a residual risk that additional investment may be needed during 2025-30. To manage this residual funding risk, we allow a contingent allowance of £50 million for South East Water…The contingent allowance will allow the company to address issues in the 2025-30 period, protecting customers' interests and promoting long-term resilience…*"[78] Ofwat has therefore recognised that there is a material risk that the (non-contingent) resilience enhancement funding provided at PR24 is not sufficient and more funding is needed.

4.49 However, the contingent allowance is flawed and does not effectively plug this funding gap. This is because Ofwat's implementation of the contingent allowance is onerous, unpredictable, insufficiently responsive to need, and disproportionate. In any event, the contingent allowance is insufficiently large to address our significant and material gap of £229.9m.

4.50 Ofwat's FD set out a number of criteria and tests that need to be met before the £50m contingent allowance can be accessed:[79]

(a) *"This allowance is available to South East Water, subject to proving it is spending its enhancement allowances, its resilience programme is on target and that the company presents a submission identifying resilience schemes to be delivered."*

(b) *"This allowance requires more in period scrutiny to expenditure."*

(c) *"The company must support its submissions with assurance from an independent third-party provider with a duty of care to Ofwat."*

78 Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances, page 227.

79 Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances, pages 226 to 227.

(d) *"Investment under the resilience contingent allowance is to manage increasing risks from hazards that are beyond their [i.e. SEW's] control and not covered by other enhancement areas or base allowance areas. It is essential that the company fully sets out the hazard the investment is addressing."*

(e) *"This investment category does not cover the failure of assets that are managed through maintenance. These are funded through base costs and are not within scope."*

(f) *"We will return the £50 million, in full or in part, to customers if South East Water fails to submit a request for schemes, the request is poorly justified or doesn't deliver agreed investment to our satisfaction."*

(g) *"South East Water is to propose a price control deliverable in its initial submission to incentivise timely and efficient completion of the work in the 2025-30 period."*[80]

4.51 Ofwat also expects our contingent allowance request would be submitted no earlier than November 2026, "*give[n] the need for the company to demonstrate progress*".[81]

4.52 We raised a number of queries with Ofwat after the FD, with a view to achieving more clarity on how, in practice, this system of criteria and tests is intended to work. In Ofwat's response, we received little by way of clarification, but a large number of additional hurdles were introduced. Three (among many) additional hurdles stand out:[82]

(a) In order to demonstrate that we are spending the existing enhancement allowances, SEW is required to show how our expenditure aligns with "*approved funding profiles, including spend versus forecast data for the first 18 months of the 2025-30 AMP, supported by delivery plan submissions.*"

(b) To demonstrate that our resilience programme is "on target", SEW must show that it is (emphasis added) "*achieving agreed delivery milestones and measurable outcomes for its resilience schemes. **All** schemes should be aligned with spend evidenced to be on track compared to original delivery dates. Progress should be demonstrated through delivery plan submissions, which should include tracking of performance against milestones. This should be supported by independent assurance and evidence on expenditure and delivery profile forecasts.*"

(c) The evidence requirements that we must demonstrate to Ofwat include: 1. Systematic Risk Assessment; 2. Alignment with Resilience Objectives; 3. Best Value Optioneering; 4. Customer Protection and Cost Allocation; and 5. Independent Assurance. Each of these categories embeds a number of sub-requirements.

4.53 The design of this contingent allowance raises a large number of issues:

(a) Ofwat's query response confirms that the funding can only be used for "*new and increasing risks identified after November 2026, ensuring alignment with Ofwat's Final Determination objectives*". It is therefore not clear if schemes which were disallowed from our PR24 Business Plan at the FD (such as the Bewl WTW upgrade) could be funded using this allowance, or if it is only available for new schemes linked to new risks. Ofwat did state that "*previously disallowed resilience funding requests can be resubmitted*" but only if these schemes "*address new or increasing risks beyond those covered by base allowances or existing enhancement funding.*" In addition, 'resubmitted' schemes must also meet the high bar of "*sufficient and convincing*" evidence. If Ofwat intends the contingent allowance only to cover "*new*" risks emerging post PR24 FD, then it may not be suitable to address the existing water security challenges we face.

(b) The November 2026 start date appears arbitrary, but Ofwat has been clear in its Query Response that if SEW incurs costs prior to the allowance being granted, then these costs

[80] Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances, page 227.
[81] Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances, page 227.
[82] Ofwat, February 2025, PR24 Final Determination Inbound query, reference: OFW-FD-SEW-002.

will be out of scope of the contingent allowance and cannot be claimed retrospectively. It is not clear that substantial new evidence will be available by November 2026 which has not already been put forward in our plan – but at the same time, if SEW submits a request much later in the AMP, the window for delivery of those schemes within the AMP will become impractically narrow.[83]

(c) Ofwat's Query Response states that our submissions will be reviewed by Ofwat "*within four months, commencing once all required information is received*". While we are keen to work collaboratively with Ofwat to meet such timelines, the volume of information and analysis Ofwat has required is disproportionate, and creates clear risk of delay. Ofwat has also left open the prospect that we can submit additional evidence if it finds our initial submissions to be inadequate; and/or re-submit schemes at a later date which fail Ofwat's tests initially; and/or submit multiple different funding requests through the AMP. This system risks interminable review loops and delays – while customers suffer the consequences of needed investment being tied up in regulatory red tape.

(d) The burden of proof is highly onerous. For example:

(i) The independent assurance must include validation from an independent third party that, inter alia, there is an "*absence of double funding*" i.e. "*the scheme does not duplicate outputs already funded under base or enhancement allowances.*" This means that a third-party independent assurance provider must be sufficiently expert not only on the specific scheme in question, but also the entire cost allowance and modelling framework Ofwat put in place for the FD. This test alone is highly disproportionate and (potentially prohibitively) costly. This exercise would also be complicated by Ofwat's flawed approach to determining "what base buys" (see paragraphs 4.22 to 4.30 above discussing Ofwat's view of the implicit allowance in base models for mains and meter renewals).

(ii) Ofwat's requirement that our whole resilience enhancement programme must be tracking in line with expected spend and delivery milestones, before any new scheme can be allowed under the contingent allowance, leaves our customers highly exposed. Delivering a large infrastructure programme of the sort SEW is embarking on will always bring risk, for some schemes and projects, of unexpected delays. Therefore, the constraint that a new scheme will only be allowed if no other scheme is experiencing any delay is impractical, unrealistic and – most importantly – not in consumer interests. If a new scheme is needed, efficient and deliverable, Ofwat should accept that scheme irrespective of the delivery status of other schemes. (We also note that the existing schemes will already have their own incentive frameworks – for example via PCDs).

(e) The contingent allowance leaves Ofwat with a substantial degree of discretion, exposing SEW and our customers at risk of poorly justified or unsubstantiated outcomes. For example:

(i) Ofwat's proposed "*in period scrutiny to expenditure*" is vague and ill-defined.

(ii) The "*new and emerging risks*" test is not practical. It leaves SEW exposed to a wide uncertainty on whether or how Ofwat can assess if a risk is "new" or "emerging". In reality, risks do not emerge in a binary or clear way.

4.54 Overall, the conditions SEW must satisfy to secure funding under the contingent allowance are unclear, disproportionately high and leave Ofwat with a substantial degree of discretion, resulting in unpredictability and significant uncertainty for SEW, its investors and ultimately consumers, contrary to Ofwat's statutory duties. The approach is only likely to cause delays and uncertainty around whether the schemes in our existing plan can or will be funded meaning investment is held up and consumers must wait for much-needed infrastructure. Ofwat's proposals are also

[83] Each project has to go through the following phases: scoping, planning, environmental assessment and mitigations, detailed design, construction, commissioning and handover.

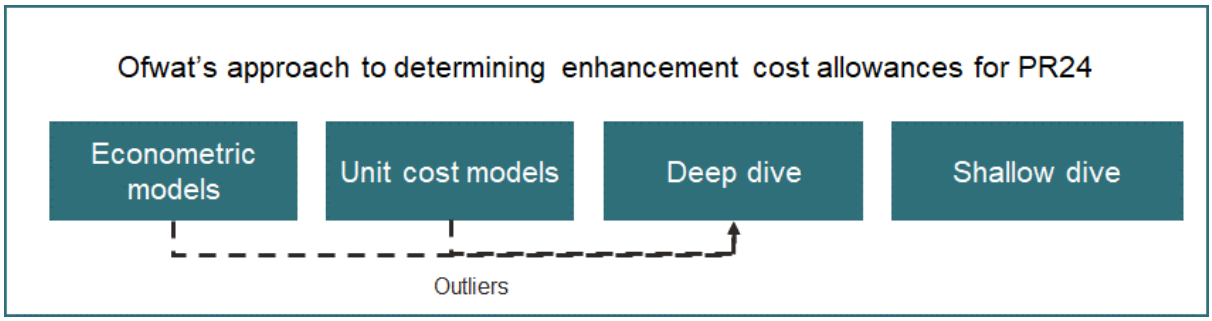
inconsistent with securing that SEW takes steps for the purpose of enabling it to meet, in the long term, the need for the supply of water to consumers (i.e. Ofwat's resilience duty) and are unnecessary and disproportionate, contradicting Ofwat's resilience and growth duties.

4.55 Having implicitly recognised the residual need, Ofwat should have set ex ante allowances accordingly, rather than putting in place an ad hoc standalone mechanism which adds to the complexity of the price control and is neither aligned with our Business Plan nor integrated into the overall FD package. Alternatively – and as a minimum – Ofwat should have put in place a contingent allowance that is 'fit for purpose' with clear, objectively understood, transparent, proportionate and targeted standards, which are aligned and consistent with its PR24 objectives. This would include a focus on ensuring predictability and coherence, adaptability and efficiency, minimising regulatory burden and avoiding unnecessary costs.

Ofwat's approach to enhancement costs at PR24

4.56 Ofwat's approach to determining enhancement cost allowances for PR24 is based on four main methods shown in Figure 4.1 below.

Figure 4.1: Ofwat's approach to determining enhancement cost allowances for PR24



4.57 **Econometric models** and **unit cost models** used data submitted by all companies and sought to explain differences in costs as a result of differences in cost drivers. In the econometric models this was captured by the independent variables. In the unit cost models Ofwat divided the costs by a single cost driver in an attempt to obtain comparative unit costs. In practice the two methods are often not dissimilar as Ofwat generally used simple cost models with a single explanatory variable (albeit regression models, if well specified, are better able to measure and allow for fixed costs that do not vary with the driver). Ofwat used a mix of company- and scheme-level models, historical and forecast data and sometimes used a single model for an enhancement line (e.g. demand reduction) and in other cases split the activities into separate "buckets" (e.g. WINEP investigations). Once the model(s) have been established, Ofwat then selected a benchmark (e.g. the median) to apply to the whole industry. Outliers were assessed separately in deep dives.

4.58 Ofwat's **deep dive approach** was based on assessing company-specific information. Figure 4.2 below shows the four tests Ofwat applied to each deep dive and how it derived the level of cost efficiency challenge:

(a) The need for investment: this included both assessing whether the investment is needed now and whether there was any overlap with base expenditure.

(b) Best option for customers: Ofwat assessed to what extent companies have considered other options and how strong the evidence for the preferred option to be the option that is best for customers.

(c) Cost efficiency: this included assessing whether the costs proposed for the scheme are efficient.

(d) Customer protection: Ofwat assessed how customers are protected from paying for the investment in the event of non-delivery. This included considering PCDs, ODIs and other incentives within the regulatory framework.

4.59 Ofwat's approach is additive. This means, for example, if a scheme received a partial pass on the need for investment with a 30% reduction, it could then receive another reduction in the other categories.

Figure 4.2: Ofwat's deep dive assessment framework for enhancement costs

Enhancement criteria grouping	Category	Cost adjustment	Justification
Need	Pass	0%	The need for enhancement is clear with sufficient and convincing evidence for enhancement need.
	Partial pass	10%-80%	Need for enhancement is partly demonstrated but concerns remain due to lack of supporting evidence. Apply bespoke adjustment based on sufficiency of evidence and degree of investment overlap.
	Fail	100%	Possible investment need, but investment is covered under base activities or previously funded. enhancements or no clear evidence for enhancement need.
Best option for customers	Pass	0%	Sufficient and convincing optioneering evidence provided to support selection of best option.
	Minor concerns	10%	Limited options considered but with evidence or range of options considered with limited supporting evidence.
	Some concerns	20%	Limited options considered with limited/no supporting evidence.
	Significant concerns	30%	No clear evidence of options considered.
Cost efficiency[63]	Pass	0%	Sufficient and convincing evidence that costs are efficient.
	Minor concerns	10%	Some cost efficiency criteria met with some supporting evidence.
	Some concerns	20%	Several cost efficiency criteria not met with limited/no supporting evidence.
	Significant concerns	30%	No clear evidence of cost efficiency.
Customer Protection	Pass	N/A	Customer protection proposed covering all costs and benefits.
	Some concerns	N/A	Some customer protection provided but does not cover all the benefits/proposed investment.
	Significant Concerns	N/A	No customer protection proposed.

4.60 The **shallow dive** approach was applied to expenditure that is less than 0.5% of the water or wastewater wholesale totex and less than £10m. For these enhancement lines, Ofwat used the results of five cost benchmarking models from other unrelated areas[84] to derive a company efficiency factor that is set between 0% and 10%. Ofwat argued that this approach was risk-based as the range of PR24 models gave a reasonable indication of a company's opportunity to reduce costs and it was proportionate to apply this to less material lines.

Ofwat's overall approach to enhancement cost assessment at PR24 is flawed

4.61 The cost gaps that arise between our DDR and Ofwat's FD are in cost areas that are predominantly assessed using unit cost models and deep dives. As a result, we have focused our analysis on these areas.

4.62 Ofwat's method for assessing enhancement costs should lead to allowances that are consistent with its statutory duties. This means Ofwat needs (among other things): to ensure that customers are protected from paying for inefficient expenditure; to ensure water companies can properly carry out their statutory functions and licensed activities; to have regard to the desirability of promoting economic growth; and to secure the long-term resilience of water supply systems. Ofwat's approach therefore needs to balance cost efficiency with the need for investment while

[84] For water these are: supply interconnectors, demand, metering, lead and raw water deterioration.

ensuring that companies deliver the best option for customers. Ultimately it is important that the price control avoids:

(a) Allowing inefficient expenditure: this could arise if Ofwat's approach was calibrated in a way that provides limited challenge to companies' proposals.

(b) Not allowing efficient expenditure: this could arise if Ofwat's approach leads to unreasonable reductions in costs and scope so that customers cannot benefit from efficient expenditure.

4.63 As a result of its excessive focus on the first of these risks, Ofwat's approach does not allow efficient expenditure that we have proposed in our plan. This will lead to a direct negative impact on customers as we will be unable to deliver the improvements that are needed to provide the services customers want. This includes water supply that is resilient to accelerating climate change and extreme weather risks, and long-term water security in a water-stressed area. Not funding efficient expenditure also affects our ability to carry out our statutory functions, such as completing statutory WINEP investigations or complying with DWI legal undertakings.

Overarching methodological issues with Ofwat's unit cost approach

4.64 **Ofwat's approach does not capture relevant cost drivers.** Despite the significant increase in enhancement expenditure allowances across the industry at PR24 compared to PR19 (c.£10bn at PR19 compared to c.£44bn at PR24), **unfortunately** Ofwat did not have sufficient dialogue or engagement with water companies at PR24. The lack of engagement, combined with a one-shot business plan, meant that we have had very little opportunity to engage constructively with Ofwat on its methods to assess enhancement costs. There was no 'Initial Assessment of Plans' stage as there was at PR19, and the DD timetable was squeezed to 7 weeks as a result of the UK 2024 General Election, so we have had effectively only 7 weeks to respond to Ofwat's entire approach to enhancement costs. For £44bn of expenditure across the industry and £775m of our own enhancement expenditure, this is clearly not appropriate. Industry dialogue is needed to ensure that Ofwat understands the potential relevant cost drivers and the comparability of different activities. This is clearly not the case at PR24 as Ofwat did not collect appropriate data on cost drivers and differences in the activities included in the costs. Ofwat has tried to remedy this by asking for further data in an ad hoc way through queries but this came late in the process and has not been an effective way of improving Ofwat's benchmarking.

4.65 **Ofwat's unit cost approach stops us from delivering the solutions that are best for customers as it is not robust.** This is because Ofwat's approach compared unit costs in areas where activities are not uniform and cost differences are not sufficiently captured by one factor. For example, the costs included in water efficiency initiatives to reduce demand include a wide range of activities ranging from customer communication campaigns to repairing leaky loos. There is no reason to expect that these have the same unit cost. Ofwat then wrongly assumed that all unit cost differences are due to efficiency. In reality, the differences in costs are driven by companies including different activities. In some instances (e.g. WINEP investigations) Ofwat has recognised this via additional deep dives yet then proceeded to base its deep dive conclusions on the flawed unit cost analysis.

4.66 Ofwat may argue that it is assessing the efficiency of the scope of the activities included at the same time as assessing cost efficiency of the programme. But this would imply that Ofwat assumes that the optimal scope of activities is the same for all companies and there are no reasons for companies to include a divergent mix of activities. Continuing the example of water efficiency initiatives, some activities deliver savings with greater certainty than others. Companies that need to implement savings with greater certainty therefore do not have the choice to move to activities that are low cost but also low certainty. An implicit assumption that the optimal scope of activities is the same across all companies therefore does not hold. Moreover, in many cases the scope of activities has been determined via the WRMP and WINEP planning processes.

4.67 Ofwat has not ensured that the scope of the costs it compares are comparable. In its approach to cost assessment pre-PR14, Ofwat asked companies to cost a number of stylised schemes (e.g. laying 1 meter of main in a certain soil type) to compare costs between companies. This

approach ensured that costings were comparable. At PR24 Ofwat has failed to ensure this and therefore comes to flawed conclusions.

4.68 We also note that, in general, Ofwat's enhancement cost modelling made no attempt to account for the generally higher costs that we face as a result of operating in the south east of the UK. In this respect we note that in the energy sector Ofgem uses ONS data to systematically assess the higher wages which are expected to be paid by utilities operating south of London, and ensure that this is accounted for in its benchmarking. In the base models Ofwat also made use of a density variable which it said could account for (among other things) higher labour costs. No such test or adjustment was made in the unit cost benchmarking that was applied across many enhancement categories, leaving us potentially systematically under-funded for efficient costs.

4.69 Ofwat's deep dive approach does not allow efficient expenditure. This is because:

(a) In its teaching materials for the CMA, Ofwat states: "*For the remaining expenditure that cannot be reasonably benchmarked we undertake shallow dives or deep dives […], based on materiality".*[85] The sentence implies that deep dives are used when benchmarking is not reasonable. As a result, we would expect the deep dives to contain engineering, asset or other expert assessments of the specific scope and costs of each scheme. In contrast to Ofwat's own statement, many of the deep dives include benchmarking but this is often done on a smaller sample size (e.g. water efficiency). Ofwat's statement is therefore contradicting the approach it took at the FD. Ofwat has not undertaken a proper deep dive assessment that is based on detailed review of the engineering evidence but instead relied on a high level, superficial review of our evidence.

(b) Ofwat's judgment was not based on a transparent methodology. In many cases Ofwat provides only a handful of sentences to explain how it has arrived at its conclusions. It is often not clear how Ofwat has come to its view. For example, it is not clear when Ofwat assesses that part of a scheme should be funded from base how Ofwat has come to this conclusion. Ofwat does not specify which activities should be funded from base. It is therefore very difficult to engage with Ofwat's method or provide further evidence or expert reports.

(c) Ofwat's framework links its level of concern to arbitrary cost reduction. There is no rationale for why the reductions for two of the categories are between 0% and 30%. A detailed deep dive should come to its own view on a case-by-case basis.

(d) The assessment of the best option for customers was focused on testing whether the company can provide evidence that it had considered different options and ultimately had chosen the best option for customers. While it is in the interests of customers for companies to have assessed options, that is primarily because a good options assessment should result in a business plan which delivers the best combination of efficient spend and improved outcomes for customers. In other words, a company which had not assessed the options would naturally be shown to be inefficient on Ofwat's efficiency tests. Any "best option" disallowance is therefore simply duplicating the efficiency test (and indeed, there are instances where Ofwat accepts that spend is efficient yet still disallows funding based on the best option test, which is logically inconsistent). In addition, even where Ofwat identified a concern that a company has not proposed the best option, Ofwat did not itself impose a requirement that a different option is to be taken. Instead, an arbitrary penalty is applied, but the allowance that remains is implicitly there to fund the very same option that Ofwat has judged is not in customers' best interests. Ofwat also made no attempt to assess whether the best option for customers could in fact be more costly: its approach can only lead to a reduction in costs. It therefore appears to be no more than a duplicative and arbitrary cost efficiency challenge.

[85] Ofwat, 12 February 2025, Setting expenditure allowances at PR24: Competition and Markets Authority (CMA) teach-in, slide 18.

(e) Ofwat assessed each test individually and then added up the total cost challenge. It does not make sense for the cost reductions applied as a result of the assessment in each category to be additive for the following reasons:

(i) Ofwat did not make clear that for discrete investments the needs assessment should lead to a binary outcome. While some deep dives were applied to programmes that are scalable, discrete investments such as an interconnector or water treatment works upgrade are binary.

(ii) If the need is accepted, then the best option for customers effectively penalises companies that have not demonstrated that they have considered a range of options. However, this penalty was then added to the cost cut as a result of the needs assessment. This could lead to a proportion of allowed costs that are not realistic for the scheme.

(iii) The cost efficiency assessment was then applied separately. In its FD Ofwat slightly revised this approach to "*Only apply […] cost efficiency challenges in addition to optioneering challenges where there is evidence that these are appropriate*".[86] This effectively acknowledges that it does not make sense to set up an additive assessment.

4.70 Instead of using a framework that is additive, Ofwat should consider each of the tests and then derive the overall cost challenge on a case-by-case basis. Ofwat's mechanistic process leads to cost reductions that are unreasonable and not well-evidenced.

4.71 In some deep dives Ofwat reversed the burden of proof as it stated: *"the company does not provide sufficient and convincing evidence to demonstrate that the proposed investment is not covered by base allowance"*.[87] Ofwat used this as a reason to reduce costs at the FD, and in some cases to remove our requested costs entirely. This implies that it is up to the companies to prove no overlap rather than for Ofwat to show that there is overlap, even though we have developed our programme based on Ofwat's definitions of base and enhancement expenditure. Proving a negative puts an unreasonable burden on companies.

Ofwat's shallow dive approach is flawed

4.72 Ofwat argued that the shallow dive is appropriate as the models it uses gave a reasonable indication of a company's opportunity to reduce costs. We do not agree as: (i) the shallow dive approach ignores evidence that is directly relevant for specific schemes (e.g. raw water deterioration) and (ii) Ofwat's aggregation of model efficiency scores for SEW is flawed. First, for raw water deterioration enhancement, Ofwat found all schemes which it could benchmark to be efficient. But for the one SEW scheme which it shallow dived, Ofwat assumed it to be inefficient based on benchmark evidence from completely unrelated enhancement schemes. This is illogical and inconsistent with Ofwat's duty to have regard to the principles of best regulatory practice.[88] Second, there are also specific issues with Ofwat's application of this approach to SEW. Ofwat only has data for 3 out of 5 models for us and this shows that we are efficient in 2 out of 3. However, if Ofwat used our supply interconnectors in the appropriate model, this would show that we are efficient in 3 out of 4 areas where data for us is available. We do not agree that this would lead to the highest shallow dive cost efficiency challenge of 10%.[89]

Overview of issues specific to our enhancement cost gaps

4.73 As mentioned above, most of our cost gap stems from unit cost assessments or deep dives. Ofwat used multiple tests to assess the allowance for enhancement expenditure. Our enhancement

86 Ofwat, December 2024, PR24 Final Determinations: Expenditure allowances, page 103
87 For example, Ofwat, December 2024, PR24 Water Resilience model (redacted).
88 Section 2(4) WIA91.
89 More detail is available in Annex G (Enhancement costs), Issue 4.

programme passes many of these tests so for most areas there is a single specific test that is in contention. There are three distinct issues:

(a) **Ofwat has misunderstood the need for investment in its deep dives:** this means Ofwat has disallowed significant schemes through an inappropriate assessment of the need for investment. Ofwat's comments on our schemes demonstrate that it has not carefully considered the evidence and therefore it has disallowed needed and efficient expenditure.

(b) **Ofwat's method to assess cost efficiency is arbitrary and ignores compelling evidence:** this means Ofwat has not allowed efficient costs to deliver our schemes. Even where we put forward strong third party evidence, Ofwat has ignored this evidence. This results in cost allowances that are not realistic. These issues arise in unit cost comparisons, deep dives and shallow dives.

(c) **Ofwat's assessment of PR19 and base overlap is incorrect:** this means Ofwat has wrongly disallowed PR24 enhancements costs on the basis of an overlap with previous funding, where no such overlap exists.

4.74 Table 4.3 below shows the issue(s) that apply to each scheme.

Table 4.3: Summary of issues with Ofwat's assessment of SEW enhancement costs

Scheme	Misunderstanding the need for enhanced investment	Arbitrary cost Efficiency imposed	Incorrect base or PR19 overlap assessment	Shallow dive assessment issues
WTW Bewl	✓			
Service reservoir capacity increases		✓		
SRN WTW upgrade (River Medway scheme)	✓	✓		
Resilience interconnectors	✓		✓	
Smart Network	✓		✓	
Leakage – Other leakage		✓		
Investigations		✓		
Water efficiency initiatives		✓		
Lead	✓			✓
Net Zero	✓		✓	
Cyber		✓		

Scheme	Misunderstanding the need for enhanced investment	Arbitrary cost Efficiency imposed	Incorrect base or PR19 overlap assessment	Shallow dive assessment issues
SEMD		✓		
Raw water deterioration	✓	✓		✓
Drinking water protected areas		✓		

Issue 1: Ofwat has misunderstood the need for our investments in its deep dives

4.75 We have identified four enhancement lines where Ofwat has misunderstood the need for our investment in its deep dives. The enhancement lines include:

(a) **Bewl WTW** is one of our treatment works in the Kent region and is [redacted]. We have included a scheme to upgrade Bewl WTW's capacity from[redacted] Ml/d to [redacted] Ml/d to improve resilience. In its deep dive assessment Ofwat gave this scheme a full pass for "best option for customers" and "cost efficiency", but failed the "need for investment". It stated that it had not seen sufficient and convincing evidence of the need to upgrade Bewl WTW beyond our current AMP7 upgrade that takes its capacity to [redacted] Ml/d. In particular, Ofwat said it was seeking evidence that Bewl WTW would continue to experience issues once the AMP7 upgrade to [redacted] Ml/d is delivered. Ofwat has wrongly assumed that the additional capacity at Bewl WTW added in AMP7 can provide additional headroom in extreme weather events. This is not the case as the AMP7 upgrade is a direct replacement of water previously produced at Hazards Green WTW, which will be lost due to reductions of raw water transferred to that WTW from Darwell Reservoir, as required by the EA and therefore provides limited additional resilience. Ofwat has accepted similar analysis for other upgrades (for example works at Tonbridge WTW and Pembury WTW are fully funded).

(b) **Removal of lead pipes** is an important activity as lead pipes pose a health risk. As part of a legal undertaking to the DWI (Undertaking SEW-2023-00016), we have to complete various activities including to "*conduct a survey of all company and service pipes to determine composition and the location of lead pipes in AMP8.*"[90] We have proposed a programme that is consistent with our legal obligations. Our programme is industry-leading[91] as we do not propose to rely solely on modelling of lead pipes but propose to conduct extensive surveys in line with our undertaking. Ofwat has assessed our programme in a deep dive. It is not clear why Ofwat duplicated the DWI's needs assessment: it is the DWI's remit to assess the need for investments related to drinking water quality and Ofwat's assessment should in this case be limited to considering the cost efficiency of our programme. However, Ofwat has split our programme into seven components and applied a full deep dive assessment:

(i) For five components Ofwat passed the need and applied a shallow dive cost efficiency challenge. We do not agree with this approach as this means applying a cost efficiency challenge from unrelated activities to an area of great importance to

90 DWI, 24 April 2024, South East Water Limited – AMP8 Lead Strategy Acceptance Notice.

91 DWI has acknowledged that *"No company holds a complete dataset of pipe material, and the number of lead supply pipes and communication pipes are estimated. South East Water proposes to survey all service pipes (communication and supply) within the company area, this will provide a wealth of information which can be used for future targeted work on replacements"*. DWI, 2023, Drinking Water 2022: Public supplies England.

public health. In addition, the basis for Ofwat's shallow dive cost challenge is flawed as it does not include the interconnectors we submitted as supply interconnectors.[92]

(ii) For two of the components Ofwat failed the needs case and had significant concerns around "cost efficiency" and "best option for customers". Ofwat suggested that our proposal goes too far and instead we should rely on existing approaches such as lead predictor models. Ofwat has misunderstood the need for the programme, including the relevance of our legal undertaking and the importance of our approach to improve public health. Ofwat's reasoning implies that no company could move the industry beyond existing approaches and customers would never see the benefit from more comprehensive approaches to removing lead. Ofwat also argued that our stop tap survey goes beyond the Strategic Priorities set by Defra. However, Ofwat has interpreted Defra's guidance too narrowly. The DWI's acceptance of the undertaking is presented on behalf of the Secretary of State for Environment, Food and Rural Affairs. This inconsistency between regulators is an issue that was recently raised in the Cunliffe review and should not prevent us from delivering important public health benefits for customers.[93]

(c) We have proposed three schemes under **net zero:** two upgrades to treatment plants and electrification of our vehicle fleet. Ofwat has applied a bespoke three phase deep dive assessment that is specific to net zero. Only two of 31 water schemes pass Ofwat's assessment (6%), in contrast to the wastewater side where Ofwat has allowed 31 out of 91 schemes (34%) as a result of the bespoke deep dive. Ofwat appears to have applied the criteria inconsistently between water and wastewater schemes that are focused on process emissions. Ofwat has failed two schemes to upgrade Ozone treatment plants in Arlington and Barcombe as Ofwat misunderstood the need and wrongly states that the scheme is not primarily driven by net zero. Ofwat argued that the primary driver for the schemes is to reduce costs through reductions in energy demand. However, this conclusion is wrong: we have included these schemes for the sole purpose of reducing emissions (923 tonnes CO2e per annum) and the operational cost savings are minimal when compared to the capex required. The current relevant equipment has a remaining asset life of 9 years and there are no operational issues so the only reason to upgrade the equipment now is to reduce emissions. Ofwat argued that the electrification of the fleet should be funded from base as it has allowed a £1m uplift for climate change adaptation. This is insufficient. Overall, we have followed Ofwat's guidance on first considering how to eliminate emissions in the lifecycle[94] but Ofwat's funding decisions are inconsistent with this guidance. Ofwat's decision to reject all of our net zero schemes on misguided pretexts is also inconsistent with its forthcoming climate change duty under the Water (Special Measures) Act 2025 (not yet in force).

(d) **Raw water deterioration:** enhancement expenditure aims to deliver a step change in risks that affect raw water quality from chemical and microbiological parameters such as nitrates (NO3), poly fluoroalkyl substances (PFAS, also known as "forever chemicals") and turbidity (NTU). Our enhancement programme primarily covers interventions at our WTW such as ultraviolet treatment, ion exchange, adsorption, filtration and blending – but also includes some catchment management schemes (CM). Our raw water deterioration enhancement programme is supported by the DWI. Ofwat used a combination of benchmarking, deep and shallow dive assessments that lead to a net cost gap of £2.6m. We have identified two issues with Ofwat's approach: (i) Ofwat incorrectly applied a 100% cost challenge to [redacted] despite this being re-categorised by the DWI as a tier 1 scheme;[95] and (ii) the cost efficiency assessment for two schemes leads to unjustified cuts as it is based on inconsistent use of Ofwat's approach. In addition schemes assessed at PR24, updated DWI guidance published in August 2024 requires us to deliver an additional scheme to address poly fluoroalkyl substances (PFAS) ([redacted] at a cost of £4.8m) and conduct further 5 catchment studies (at a total cost of £4.2m). Ofwat was not able to

92 More detail is available in Annex G (Enhancement costs), Issue 4.
93 Independent Water Commission, 27 February 2025, Call for Evidence.
94 Ofwat, January 2022, Net zero principles position paper, page 9.
95 Ofwat has stated that this will be deferred to the PFAS uncertainty mechanism. We do not agree with this approach as the DWI notice was provided within the time window for schemes to be considered in the FD.

assess these requirements in the FD as they were published too late in the process. While Ofwat has introduced an uncertainty mechanism for notices published post 20 December 2024, these requirements were published too early to be considered for the uncertainty mechanism but too late to be considered in the PR24 FD. We therefore ask the CMA to allow £9.1m of funding to deliver these schemes.

(e) **Smart Network:** Ofwat inappropriately reallocated £11.3m of our planned expenditure to the leakage category, and then disallowed this amount on the basis of a deep dive which found that the spend had no leakage benefit and therefore was not needed. This reallocation was wrong given that we always identified the primary benefit of the Smart Network programme was to deliver improved risk management on Water Supply Interruptions and we had already allocated the costs related to any leakage benefits to "other leakage" costs. Our Smart Network scheme should be assessed as a single overall package, without arbitrary re-allocations. Ofwat also rejected expenditure in this area on the basis of base overlap, as discussed further in paragraph 4.81 below.

Issue 2: Ofwat's method to assess cost efficiency is arbitrary and ignores compelling evidence

4.76 There are eight enhancement lines where Ofwat's cost efficiency assessment leads to disallowing efficient costs and ignores compelling evidence. These include:

(a) Aggregate **Leakage** costs were split by Ofwat into mains renewal costs; costs for addressing customer supply pipe leakage (**CSPL**); and Other Leakage Activities.[96] Mains replacement is primarily covered by base expenditure under Ofwat's PR24 approach; while CSPL is covered within metering – these are discussed in the base costs section above. Our focus here is therefore on Other Leakage Activities (**OLA**), which Ofwat says includes activities like pressure management and active leakage control. Reducing leakage via these activities is a key element in ensuring water security, by reducing demand on the system.

Ofwat has calculated allowances for OLA using a unit cost benchmark which results in an allowance of £18.8m for SEW, a 56% challenge compared to our request of £43.1m. Ofwat allowed a higher unit cost for the top 5 'high-performing' companies on leakage in the sector, which are identified based on a range of performance metrics. SEW is in this high-performing group. We agree with Ofwat that our higher performance starting point leads to higher marginal costs to achieve further improvement.[97]

However, the unit cost Ofwat used to set our allowance is inappropriate. Our allowance was set equal to the unit cost forecast put forward by SES Water. This is flawed for a number of reasons:

(i) Ofwat's FD stated that it has used SES Water's historical unit cost. In fact, Ofwat has selected SES Water's *forecast* unit cost as the benchmark. SES Water's historical unit cost (£5.470m / Ml/d) is more than double its forecast unit cost (£2.057m / Ml/d). Had Ofwat implemented its stated (and presumably intended) methodology, our requested costs would have been fully funded.

(ii) Should Ofwat now claim the use of forecast costs was intended, this raises further problems. Ofwat's calculation of SES Water's forecast unit cost is materially affected by the outcome of its deep dive investigation into SES's 'DMA asset health and asset condition assessments (DMAAH)' programme. Ofwat appears to have made an error in failing to amend SES Water's forecast unit cost to reflect the outcome of this deep dive. In general, it is not appropriate that such a material proportion of our cost gap

96 As noted above, Ofwat has also re-allocated a proportion of our smart network scheme to leakage. We do not agree with this re-allocation and discuss all of the expenditure related to smart networks under a single heading.

97 This conclusion is also consistent with the findings of the CMA in the PR19 redeterminations. See CMA, 17 March 2021, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report, paragraph 8.59.

hinges on detailed investigations and information relating to a different company, on which we do not have visibility.

(iii) The choice of SES Water's unit cost as the benchmark is arbitrary and unjustified. Ofwat provides no rationale for departing from its standard approach of taking the median unit cost, which is the approach Ofwat uses for the non-high-performing companies; and which Ofwat has also applied for other enhancement line items.

(iv) The use of forecast data is inherently risky. Naturally, company forecasts may be distorted by, for example, varying degrees of optimism around the benefit and costs of the proposed programmes for each company. The forecasts show significantly varying unit cost expectations across the sector, with the variation too wide to be meaningfully attributable to inefficiency. There are also different unit cost projections associated with different activities,[98] but Ofwat nevertheless benchmarks these against each other. Comparing unit costs between these schemes shows high variability which is too large to be purely about cost efficiency. These risks are particularly acute for us because of Ofwat's reliance solely on SES Water to set our allowance: SES Water appears to propose a materially different activity programme to us.

These flaws result in a material disallowance of our efficient costs.

Our plan was informed using external expert consultants WRC to identify the cost effective approach to achieving leakage reduction. Ofwat's benchmarking is an entirely inadequate basis on which to conclude that over 50% of our cost projection was inefficient. Ofwat has not ensured that it is comparing like-for-like. In its approach to cost assessment pre-PR14, Ofwat asked companies to cost a number of stylised schemes (e.g. laying 1 meter of main in a certain soil type) to compare costs between companies. This approach ensured that costings were comparable. At PR24 Ofwat has failed to ensure that the unit costs are comparable.

(b) Our enhancement programme includes 6 **service reservoir** capacity increases, which forms a crucial part of our resilience strategy. Ofwat's deep dive assessment resulted in a pass on the "need for investment" and the "best option for customers". However, Ofwat has applied a substantial reduction to our cost estimate in its assessment of cost efficiency. As we infrequently increase the capacity of our service reservoirs, we sought additional assurance on our cost estimates following our initial PR24 Business Plan submission from ChandlerKBS who undertook an independent third party bottom-up industry benchmarking exercise to assess the cost efficiency of our service reservoir proposals. The ChandlerKBS report[99] shows that our initial cost estimates were c. 40% below the industry benchmark. We therefore had to revise our cost estimate upwards in our DDR, or risk being exposed to very significant underfunding. In the FD, Ofwat only allowed the amount of funding we originally requested in the PR24 Business Plan and effectively ignored the additional third party, independent, bottom-up evidence we submitted at DDR stage. The costs Ofwat has allowed mean that we cannot realistically deliver the full programme of service reservoir upgrades we proposed. Our costs are efficient, as demonstrated by independent benchmarking. Ofwat questioned the sample size in the ChandlerKBS's report. Subsequent work by ChandlerKBS[100] has shown that their assessment is based on 20 data points from 5 other water companies. The latest report also provides more details on ChandlerKBS' methodology demonstrating that their report set out a robust estimate of efficient costs.

(c) [redacted]

98 SEW's plans revolve primarily around a "find and fix" programme: all companies who sent the relevant data to Ofwat project that this is more expensive than the "pressure management" activities.

99 ChandlerKBS, 21 September 2023, Independent Cost Benchmarking – PR24 Cost Curves.

100 ChandlerKBS, March 2025, Industry Cost Modelling Methodology & Service Reservoirs, page 17.

[redacted].[101] Ofwat used its deep dive approach to align our contribution with the determination it has made for Southern Water. We note that Southern Water has also referred its FD to the CMA so there is some uncertainty around the final allowance following the redetermination process. Our key issue is that we face an ex ante costs gap of £6.77m compared to our share of SRN's estimated costs for the scheme, and we are exposed to any cost overrun that goes beyond our ex ante allowance and therefore bear a risk that we cannot influence. The costs requested by Southern Water and allowed by Ofwat or the CMA are not within our control and the outturn costs are outside of our influence. It is therefore not reasonable for us to bear 25% of any overspend against the allowance as this uses up funding which could otherwise be deployed on the critical investments our customers need. The appropriate remedy is to allow us the necessary costs ex ante, and implement a true-up mechanism which would cover our share of any cost overruns. In the absence of such mechanisms, we are exposed to undue risk without having any way to reduce or mitigate this risk.

(d) **Water efficiency initiatives** We have proposed a programme of demand reductions that is focused on achieving reductions that are sustainable and can be delivered with relatively high certainty. These are crucial to ensuring future water security Since the DDR, we have continued to optimise our programme delivery and have therefore revised our cost estimate to £40.2m. This still leaves us with a material gap as Ofwat has only allowed £24.1m. Ofwat used a unit cost comparison to determine its cost allowances in this area. This does not take into account why companies have chosen different activities. As our costs are materially higher than the benchmark selected by Ofwat, Ofwat applied a deep dive approach. Our proposed activities passed the need for enhanced investment and were judged to be the best value for customers. To assess cost efficiency, Ofwat used an arbitrary mix of unit costs of 7 company programmes that largely cover home visits. It took the average of these costs and applied a 10% reduction. There is no rationale for this approach and it is not clear why our costs should be comparable to comparators selected by Ofwat. Ofwat has ignored our evidence that demonstrates that we have selected a programme that has a high degree of certainty and sustainability. For example, our programme includes fixing "leaky loos" which has higher unit costs than media campaigns but delivers savings with greater certainty and sustainability. We chose to use independent costs in this area basing our costing on industry-wide studies.[102] We do not agree with Ofwat's cost efficiency challenge and would be forced to use lower certainty methods that are unlikely to deliver sustainable water savings if the approach was maintained or do fewer certain schemes delivering less overall benefit. This would ultimately lead to more expensive supply-side investments that will be more costly for customers and the environment.

(e) As part of the **WINEP**, we are required to undertake 36 **investigations** into various areas of environmental impact. 25 of these are complex investigations and 11 are simple. In response to criticism of the DD approach Ofwat used a 'triangulated unit cost' benchmarking approach to initially estimate company allowances based on three drivers. However, the resulting allowances for many companies (including SEW) were deemed too low by Ofwat to be credible. Ofwat therefore rejected the model and assessed our investigations programme through a deep dive instead. Ofwat passed our investigations programme on the need for enhanced investment and judged it to be the best option for customers. However, Ofwat applied a cost challenge on the basis that some concerns remain around the cost efficiency of the programme.

We do not agree with Ofwat's approach as its deep dive conclusion seems to be primarily driven by a reliance on the very same benchmarking results which it deemed not credible (resulting in the requirement for a deep dive in the first place). Further, the improvements Ofwat claimed to have made between DD and FD (by introducing its 'triangulated' approach) have evidently not improved the unit cost benchmarking; and ignored a number of the substantial concerns we raised. The results of the deep dive analysis seem arbitrary: SEW receives a 20% reduction while others receive only a 10% reduction, despite no

[101] The Medway Water (Bewl Bridge Reservoir) Act 1968, and the River Medway Scheme Agreement dated 1 July 1963, as amended on 3 January 1972.

[102] See Artesia Consulting, 2025, South East Water Review of AMP8 water efficiency programme.

obvious reasoning or evidence being provided to justify a higher disallowance for us. Ofwat has also allowed all wastewater investigations in full and without challenge and introduced a specific cost sharing rate to deal with ex post over/underspend, but has failed to apply the same approach for water investigations. There is no valid reason for this inconsistency. Overall Ofwat's cost efficiency challenge is unreasonable as it does not reflect the nature of our specific investigations.

(f) Our **Cyber** scheme aims to [redacted]. This is to comply with the increasing standards included in the Government guidance and DWI requirements. Ofwat has used a deep dive approach to assess our Cyber security scheme, and agreed that the scheme is the best option for customers and meets the investment need criteria. Ofwat has expressed concerns with cost efficiency for the scheme, and made a 5% adjustment to the allowance. Ofwat has stated that it has not seen evidence of the third-party assurance to confirm the result of the assurance process. We do not agree with Ofwat's findings. Our Cyber Assessment Framework submission has gone through an audit process by AtkinsRéalis. The cost estimates for this scheme are based on our internal cost curves. Our cost curves were subject to a benchmarking exercise by ChandlerKBS both at draft business plan stage and for our DDR, and it was found that our cost curves are lower than the industry average. Our unit cost database and methodology were updated and reviewed by Faithful-Gould (SNC-Lavalin Group) as our quantity surveyors. This confirmed the correct cost curves were used for this scheme's cost estimates.

(g) To comply with the updated Security and Emergency Measures Direction (**SEMD**) as regulated by the DWI, [redacted]. Based on a new significant extreme weather event experienced in 2022, [redacted]. Ofwat has used a deep dive approach to assess the enhancement case, and found that the scheme is the best option for customers and it meets the investment need test. Ofwat has applied a 10% adjustment to the allowance, stating that it has not seen a bottom-up approach that sufficiently evidences scheme element costs being efficient, and that the benchmarking provided has not included activities that are similar to those included in the SEMD scheme. This directly contradicts Ofwat's own approach to the shallow dive where it uses the cost efficiency challenge for unrelated enhancement lines to challenge costs that are less material. Ofwat's findings are wrong because we have demonstrated the cost efficiency of the different elements of our scheme via vendor engagement on tankers (which Ofwat accepted), unit costs for buildings based on our unit cost database that is found efficient when compared with the rest of the industry, and a thorough cost-benefit process for identifying the lowest cost option for the opex components. Where the elements comprised non-standard assets and activities, we have demonstrated cost efficiency through alternative methods.

(h) Expenditure included under the **Drinking Water Protected Areas programme** (DrWPA) enhancement line covers both improving and protecting the quality of drinking water sources. Ofwat has applied a 10% cost challenge as a result of a deep dive. Ofwat states that it would have expected to see more evidence on the cost-build up and benchmarking process to justify our relatively high unit costs. However, Ofwat has not taken full account of our evidence. Each scheme has been informed by a previous investigation during AMP7 and a report by expert consultants (AtkinsRéalis) using a consistent bespoke bottom-up costing profile which adequately reflects the scale, drivers and characteristics of each drinking water source. The costing methodology has also been shared with stakeholders and regulators throughout the development of the programme, and the resulting costs have been extensively audited.

Issue 3: Ofwat's assessment of PR19 and base overlap is incorrect

4.77 In some of its deep dive assessments, Ofwat has applied a cost efficiency challenge as part of its need assessment as it believes that there is overlap with either base expenditure or PR19 enhancement funding (or both). We disagree with both types of adjustments.

(a) For overlap with base expenditure Ofwat provides little information on how it has come to the view that there is an overlap. It does not provide a list of activities and instead applies reductions in the order of 20%. Our plan was developed consistent with Ofwat's definitions for base and enhancement expenditure and Ofwat's lack of transparency means that we cannot properly engage with its assessment.

(b) For overlap with PR19 expenditure, Ofwat's assessment is not aligned with the approach to PR19. As discussed in detail in Annex E (Growth and resilience), Ofwat advertised the flexibility to move expenditure between areas (as long as the overall outcomes were delivered) at PR14 and PR19 as a positive feature of the regulatory system. This meant that there were no obligations on companies to deliver specific schemes, but instead companies had flexibility to deliver the package of outcomes with the overall totex allowed. To retrospectively apply requirements in relation to schemes proposed at PR19 and disallow expenditure at PR24 is therefore inappropriate.

4.78 There are two enhancement lines that have reductions as a result of base or PR19 overlap: resilience interconnectors and smart network:

4.79 **Resilience interconnectors:** To increase resilience, we need greater flexibility to transfer water between water supply zones and sub-zones so that water can be moved to where it is needed most. We therefore have included nine resilience interconnectors in our programme and seven sub-zonal interconnectors.[103] Ofwat uses its deep dive approach and modelled cost efficiency using a simple econometric model. Ofwat has assessed the zonal and sub-zonal interconnectors as being the best option for customers and as cost efficient:

(a) Interzonal interconnectors are on average 20% more efficient than Ofwat's model; and

(b) Sub-zonal interconnectors are on average 38% more efficient than Ofwat's model.

However, Ofwat applies a cost reduction as a result of its need assessment. Ofwat has incorrectly determined that there are base overlaps and PR19 funding overlaps for several of the zonal and sub-zonal interconnectors. This applies to:

(c) PR19 overlap identified for [redacted] and Ashford improved supply resilience interconnectors;

(d) Base overlap identified for Groombridge reinforcement and [redacted] to support Hartley system; and

(e) Ofwat has stated that it is not convinced that there is no base or PR19 overlap for [redacted], Poverty Bottom & Underhills Deficits and [redacted].

Ofwat's assessment of base and PR19 overlap is wrong. First, for schemes with alleged PR19 overlap, Annex G (Enhancement costs) describes in detail that there were no explicit requirements to deliver specific schemes at PR19: we used our cost allowances to re-optimise after Ofwat cut our funding at the PR19 FD and we prioritised resilience and we subsequently overspent against our allowances in total across AMP7.[104] As a result the reductions as a result of PR19 overlap are not justified, have rewritten the PR19 approach, and should be removed. Second, for schemes with base overlap, Ofwat's assessment is wrong. Both schemes are clearly targeted at providing additional capacity, as evidenced in Annex G (Enhancement costs). Third, for the schemes where Ofwat is not convinced that there is no base or PR19 overlap, Ofwat's statement shows that it is not clear that there is overlap but it is putting the burden of proof on companies. This is unreasonable and unjustified.

[103] Ofwat has assessed our supply interconnectors as resilience interconnectors as it does not consider the WAFU (water available for use) benefit to be consistent with the suppler interconnector category. While we disagree with this approach, we discuss all interconnectors under resilience in the interests of simplicity.

[104] Ofwat disputes this. Our detailed response can be found in Annex G (Enhancement costs), paragraphs 96 and 115 to 155.

4.80 **Smart network**: Our enhancement programme includes an important £58.9m investment in a smart network that represents a shift from traditional operations [redacted]. As discussed above, our network is characterised by a large number of relatively small assets with changing demand patterns and high population growth. A smart network would allow us to react much more rapidly to unforeseen events and substantially enhance our resilience. Our PR24 Business Plan allocated £10.8m of this programme into Other Leakage (see discussion of flaws in Ofwat's approach to OLA above). Ofwat then shifted a further £11.3m into leakage and disallowed this on the basis of a deep dive, in which Ofwat concluded the spend was not needed because it did not deliver leakage benefits – even though we did not identify significant leakage benefits from this spend in the first place (the primary benefit for our customers from the Smart Network is to reduce Supply Interruptions, but a range of secondary benefits will also be delivered from the spend).[105]

For the remaining £36.8m of smart network spend, Ofwat also assessed this in a deep dive. This spend passed Ofwat's cost efficiency test but it failed the needs test, as Ofwat stated that it should be covered by base expenditure. We disagree with Ofwat's approach because:

(a) The smart network clearly delivers a step change in capacity and quality of service through allowing [redacted] through comprehensive roll out of new technologies, and therefore qualifies as enhancement expenditure. Previous installations of smart infrastructure were different because they were limited small-scale trials and not at the scale and comprehensive coverage we need from our water smart network.

(b) The investment is clearly needed now to provide additional resilience and provide customers with a better service (see further Annex G (Enhancement costs), Section 3.1).

Requested remedy

4.81 The CMA should adjust our enhancement costs allowances to fill the gaps left by Ofwat's PR24 FD, by uplifting funding in accordance with the blue-shaded cells in table 4.2. This would amount to an uplift of £218.3m in AMP8 totex.[106] It should also fund the additional PFAS raw water deterioration schemes at £9.1m, resulting in a total enhancement costs uplift of £227.4m. In total we are therefore requesting £754.1m of enhancement funding. The CMA should evaluate the need for any adjustments to PCDs linked to our enhancement schemes as it considers appropriate.

4.82 Should the CMA find that any of our enhancement cost proposals are not at this stage sufficiently evidenced, but may become necessary in future in order to address resilience challenges, it should retain a version of the contingent allowance, but amend this mechanism to ensure that it is clear, objectively understood, transparent, proportionate and based on targeted standards, which are aligned and consistent with its PR24 objectives. This would include a focus on ensuring predictability and coherence, adaptability and efficiency, minimising regulatory burden, avoiding unnecessary costs and ultimately on the best interests of customers.

Frontier shift

4.83 Ofwat's costings incorporate a 1% per annum allowance for ongoing frontier shift. This is broadly the same figure that has been factored into price reviews going back to the late 2000s/early 2010s, despite evidence of a marked slowdown in economy-wide productivity growth since the global financial crisis.

---

105 Our smart network programme is an enabler for a more efficient leakage reduction programme, but we did not include any direct leakage benefits in relation to our smart network proposal, so Ofwat has misunderstood the need for the investment.

106 Note that the "Gap" shown at the bottom of Table 4.2 is the total gap between the PR24 FD and our view of efficient costs, but as explained above, we are asking the CMA to reconsider only the enhancement lines shaded blue in Table 4.2, in respect of which the gap equals £218.3m. The CMA should also fund the additional PFAS raw water deterioration schemes described above at £9.1m.

4.84 The debate about the applicable rate of frontier shift in the water industry, and in regulated industries, has become stale and predictable over recent years, with Ofwat maintaining its 'standard' 1% figure despite representations from companies that historical rates of productivity growth are no longer likely to be achievable. We request that the CMA brings a fresh pair of eyes to this area and identifies what a reasonable expectation for ongoing productivity growth in the industry – and, just as importantly, in the contractor market – ought to be in light of the prevailing economic outlook.

4.85 To assist the CMA, we are providing the Frontier Shift Report alongside our Statement of Case; the key points are summarised below.[107]

Water industry frontier shift should reflect economy-wide productivity growth

4.86 Under a benchmarking analysis (and using a stable method over time) water industry frontier shift should be higher when economy-wide productivity growth is higher, and lower at times of low productivity growth

4.87 The UK has been experiencing flat, near-zero, productivity growth since the financial crisis in 2008. This should be reflected in Ofwat's frontier shift target. However, the target has: (a) trended up over time in contrast to this slowdown; and (b) is set at a level that suggests Ofwat expects the water sector to significantly outperform the wider UK economy.

4.88 Most water companies proposed a lower frontier shift target in their business plans, based on the range recommended by Economic Insight in an industry-wide study ahead of the business plan submissions.[108] This range already embedded a material improvement in productivity growth from the current levels exhibited by the wider UK economy, and provided a stretching target in this context.

4.89 In the PR24 FD, Ofwat presented two arguments, based on Europe Economics' advice, for why the target should be set above levels indicated by the raw Total Factor Productivity (**TFP**) data: (a) TFP may understate the scope for frontier shift, due to it being depressed by increased productivity dispersion (negative catch-up efficiency) during the financial crisis; and this may reverse over PR24, due to the exit of unproductive 'zombie firms' (arising from a 'tightening' of monetary policy); and (b) new technology (in particular AI) may also lead to productivity performance improving over PR24, including in the water industry.

4.90 However, Ofwat's arguments in the PR24 FD are unsupported by the evidence:

(a) Recent economic forecasts don't suggest significant productivity improvements, and the claim that catch-up efficiency was negative during the financial crisis is not supportable because:

(i) Ofwat has crucially not tested, nor therefore established, that this claim holds for its comparator industries in the UK; and moreover

(ii) To the extent data relevant exists to test the claim, it contradicts Ofwat's position.

(b) Furthermore, the relevant data shows no clear link between unproductive 'zombie firms' and UK's low productivity (and recently expert economists at the Bank of England and ONS have been dismissive of the idea that zombie firms materially explain productivity performance).

(c) Independent technology experts do not identify the water industry as being likely to materially benefit from the new technologies cited by Ofwat.

[107] Economic Insight, March 2025, Frontier shift at the PR24 Redeterminations.
[108] Economic Insight, 28 April 2023, Productivity and frontier shift at PR24.

The main factors causing the slowdown in UK productivity are 'economy wide'

4.91 The main factors causing the slowdown in UK productivity are 'economy-wide' and so must also affect the water sector.

4.92 How closely frontier shift in the water sector tracks productivity trends in the wider UK economy depends on the extent to which the water sector is affected by the same factors driving productivity growth in the economy more broadly. The evidence shows that this is the case to a significant extent:

(a) The main causes of the UK productivity slowdown are: extent of private and public investment, quality of infrastructure, quality of human capital stock, and management quality. All of these factors affect the water sector equally as much as they affect the wider economy.

(b) The long lifetime of assets in the water sector means that new technologies often cannot be rapidly adopted at efficient cost.

(c) The water sector involves provision of "basic" services for which the means of production (e.g. pumping water around a network) cannot be fundamentally transformed, in contrast to some other areas of the economy.

The water industry is not intrinsically 'high-tech'

4.93 In the FD, Ofwat argued that the examples of innovation projects in company business plans demonstrated the scope for innovation in the water sector.

4.94 It is true that all industries have some scope for innovation, but Ofwat's argument misses the point. The question is whether the water sector is 'high-tech' relative to other sectors, and, therefore, whether it is reasonable to expect it to outperform the wider economy on productivity growth (due to it having greater relative potential to benefit from technology).

4.95 Ofwat's argument that the water sector can reasonably be expected to outperform the wider economy is speculative because there is no substantive evidence to support this. In contrast, the results of a survey of technology experts conducted by Economic Insight indicate that the regulated water sector is expected to experience smaller productivity gains from technological trends than nearly every other industry in the UK.[109]

Remedy

4.96 In light of the concerns with Ofwat's analysis outlined above, we maintain that a frontier shift target of 0.5% p.a. is stretching and deliverable, consistent with our plan. The impact of this frontier shift remedy in revenue terms is set out in Table 4.4 below.

[109] Economic Insight, March 2025, Frontier shift at the PR24 Redeterminations, Annex 4.

Table 4.4: Impact of frontier shift remedy

	1% frontier shift	0.5% frontier shift	Net impact on revenues vs PR24 FD, AMP8
Base Costs			
Ofwat FD (£1,171m pre FS/RPEs)	-£23.23m	-£4.69m	+£18.54m
SEW base costs remedy (£1,300m pre FS/RPEs)	-£32.23m	-£6.48m	+£25.75m
Enhancement Costs			
Ofwat FD (£576.7m pre FS/RPEs)	-£13.7m	-£2.0m	+£11.7m
SEW enhancement costs remedy (£754.1m)	-£17.9m	-£2.6m	+£15.3m

5 Outcomes

Ofwat's approach to water supply interruptions is unfair, disproportionate and punitive, and inexplicably disconnected from the timing of our related resilience investment.

The CMA should adopt the following approach:

(i) Adjust the WSI PCL as described below to take into account the timing of our investment programme and lower the penalty collar to -0.5% of RoRE.

(ii) For C-MeX, modify the calculation of company performance such that any inherent regional biases are removed.

(iii) Implement a PR19 adjustment to remove the underperformance penalties associated with our PR19 NHH Voids ODI.

Overview

5.1 The outcomes framework is a key element of Ofwat's regulatory regime. The performance commitments within this framework sit alongside a wider landscape of regulatory, statutory and corporate incentives. The framework is intended to encourage water companies to deliver the service levels and outcomes that are most important to customers, and to levels that represent the best value to customers and society. We support this approach in principle, and we note that it has delivered performance benefits for customers since it was introduced in PR14.

5.2 Before considering the outcomes package in detail, it is important to recognise that ODIs are not the only financial incentive faced by water companies. Service issues, such as Water Supply Interruptions, also lead to:

(a) Guaranteed Service Standards (**GSS**) payments – these are payments for customers that are specifically affected. The Government has stated that it will at least double these payments and extend the circumstances in which they apply.[110]

(b) Operational costs of dealing with service issues, including overtime to fix issues quickly, providing bottled water tankering water, etc. Companies may also bear unanticipated additional production costs to meet peak demands, in which case their revenue is adjusted down in subsequent years to stay within the revenue cap.

(c) Repair costs – freeze-thaw events and prolonged hot periods can result in pipe bursts, which require expenditure to repair.

(d) Impact on customer satisfaction – service issues also have a direct impact on customer satisfaction and this is reflected in our C-MeX score.

When assessing the appropriateness of the outcomes package, the full suite of financial impacts needs to be considered.

5.3 At PR24, Ofwat's approach to outcomes has been characterised by:

(a) A new method for setting ODI rates that results in significant changes from PR19 ODI rates and, in many cases, substantial increases in the ODI rates. ODI rates are no longer directly linked to customer research and are determined using a complicated methodology with a

[110] Defra, December 2024, Water and sewerage: changes to the service standards.

myriad of assumptions. Ofwat explicitly stated that it is seeking to set stronger ODI rates meaning higher penalties and rewards.[111]

(b) An approach to PCLs that takes account of current performance in an inconsistent way and does not reflect company-specific circumstances.

5.4 We recognise that at the FD Ofwat made substantial changes to the package of PCLs and ODIs, responding to the DDR submissions from SEW and the rest of the industry. These changes represented a significant improvement on the package that was set out at the DD. However, two specific and significant issues remain with the FD outcomes package for SEW.

(a) The PCL and collar for **Water Supply Interruptions** are unreasonable, disproportionate and punitive. They do not take into account our company-specific circumstances and do not align with the timing of our enhancement programme to improve performance. Ofwat has singled SEW out by applying a collar of 2% and provides no reasonable basis for this punitive and differential collar, the result of which is that we are penalised twice as much as other companies in respect of the WSI PCL and four times as much as most companies for most PCLs.

(b) The **C-MeX** methodology contains regional bias that unfairly penalises SEW.

5.5 The ultimate result of each of these issues is that we are exposed to disproportionate downside risk, and this is detrimental to our customers. We face a real prospect of excessive penalties at PR24. These penalties would be unjustified and, furthermore, would damage our ability to finance the investment in the service upgrades that customers need. An FD which leads to this outcome is inconsistent with Ofwat's statutory duties.[112]

5.6 The remedies that we are proposing are designed to mitigate some of this disproportionate risk and correct the flawed and perverse incentives that remain in the PR24 FD.

5.7 However, we note that a significant downside risk still exists across the framework set out at PR24 FD. Further detail on the downside risk and our views on the Outturn Adjustment Mechanism are set out in Section 7 (Financeability and Investability), and in Annex H (Risk and Financeability).

5.8 It is also fundamental to recognise that our proposals for outcomes are predicated on our investment programme. They are conditional on the funding for the full programme of resilience, asset maintenance and wider enhancement schemes set out in Section 4 (Costs).

5.9 We set out a high-level summary of the two key issues with Ofwat's approach to the outcomes package below and provide detail of our proposed remedies. Further explanation is provided in Part A of Annex F (Outcomes and Water Supply Interruptions), which sets out the full evidence base to support our plan.

5.10 We also note that at PR24, Ofwat has applied a £3.9 million reduction to SEW's revenues related to the number of void (i.e. unoccupied and therefore non-chargeable) premises in the NHH water retail market. These penalties do not reflect harm suffered by consumers on performance, instead they stem from inconsistent and untransparent regulatory decisions in the design, setting and application of the incentive and Ofwat's poorly targeted regulatory approach. We ask that the CMA implements a PR19 adjustment to remove the underperformance penalties associated with our NHH voids ODI as part of its redetermination. This would ensure we are not unfairly penalised. Annex I (PR19 reconciliation: NHH Voids) provides more detail as to why these anticipated penalties are unjustified and punitive.

111 Ofwat, December 2024, PR24 Final Determinations: Delivering outcomes for customers and the environment, page 20.

112 See Annex B (Legal and regulatory framework). In this context, Ofwat's consumer duty, and finance duty are particularly relevant.

Specific issues with Ofwat's approach at PR24

Issue 1: The PCL and collar for Water Supply Interruptions are unreasonable

The PCL is unreasonable

Our past performance and lessons learned

5.11 The PCL that Ofwat has set is unreasonable, unrealistic, overly stretching and does not take into account crucial company-specific factors which impact our performance on WSI.

5.12 We are acutely conscious that our performance on WSI has been poor compared to the industry as a whole, and of the impact of this on our customers. As outlined in Section 2 (Our story) our recent performance has been significantly adversely impacted by the real increase in demand due to external factors outside the company's control, in particular the permanent shift in working pattern following the Covid-19 pandemic and an unprecedented frequency of extreme weather events.

5.13 This has happened despite us following the regulatory framework on water resources planning as the assumptions included within our WRMP (approved by the Secretary of State) have been exceeded. Combined with the failure of the regulatory frameworks to reflect network capacity issues and adequately fund resilience costs in previous years (as discussed in Section 2 (Our story), this has led to a situation where our WSI performance needs to improve significantly.

5.14 Table 5.1 below provides a summary of our most material unplanned WSI and the identified cause. The table shows that all of the events are related to extreme weather (freeze thaw, heatwaves and named storms). Annex D (Supporting information) explains in detail how the combination of these weather events, our network configuration and the permanent changes in customer behaviour since Covid-19 have led to these WSI.

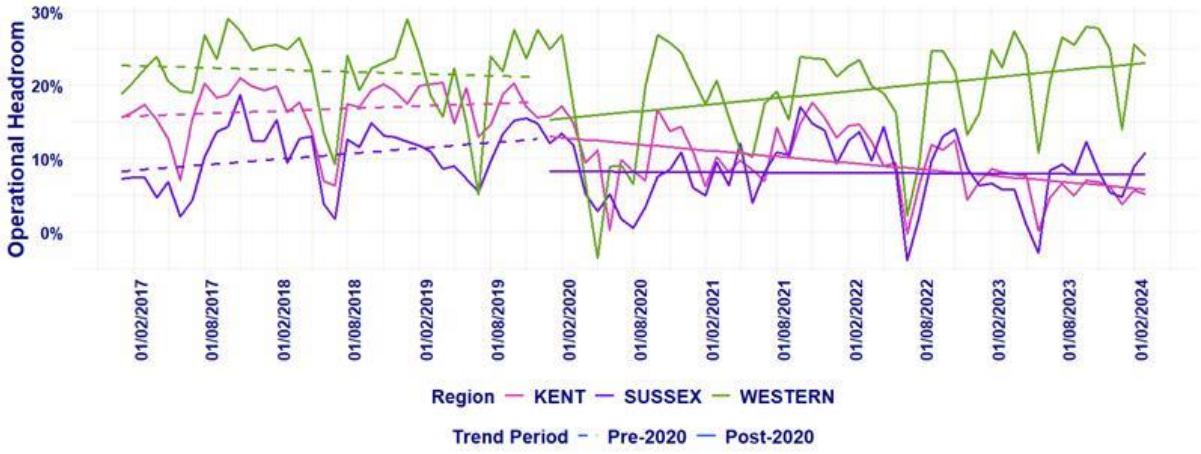
5.15 Table 5.1 also shows that none of the material events occurred in our western region. This is because for legacy reasons discussed in Section 2 (Our story), our network configuration in the western region is more resilient. The difference between our performance in the western and non-western region shows that it is not our management approach but indeed a combination of factors that require enhancement investment that are the root cause of these issues.

Table 5.1: Aggregated impact of extreme weather events on WSI from 2015

Incident	Date	Reporting year	Duration (days)	Properties Affected	Interruption minutes per property
Beast from the East	March 2018	2017/18	11	26,705	37.4
Summer 2020 Heatwave	July 2020	2020/21	9	8,129	9.8
Storm Eunice	February 2022	2021/22	7	32,234	59.5
Summer 2022	July 2022	2022/23	35	34,487	19.8
Freeze thaw 2022	December 2022	2022/23	7	42,312	118.5
Summer 2023	June 2023	2023/24	13	14,026	20.8

5.16 The underlying reason for the performance in the non-western region is the lack of operational headroom[113] caused by changes in customer behaviour and increased frequency of extreme weather leading to elevated demand. Figure 5.1 below shows the operational headroom in the western region is consistently higher than in Kent and Sussex and also shows how the permanent change in customer behaviour as a result of Covid-19 has eroded the operational headroom.

Figure 5.1: SEW – average monthly operational headroom by region



5.17 In response, we have:

(a) Reviewed any learned lessons from each WSI incident and have developed a detailed action plan with a number of short-term responses to improve our supply resilience. For example, following the freeze-thaw (Beast from the East) we published a detailed report on the lessons we learned.[114]

(b) We have implemented improvements to the information and support we provide to customers. This includes a new customer SMS notification and information tool (AquAlerter), improvements to the speed, scope and tracking of home delivery of bottled water to vulnerable customers during incidents, improvements to the planning and operation of bottled water stations (including extended opening hours, sharing of stocks with neighbouring companies, increasing engagement with local resilience forums and councils, and increasing the number of sites pre-assessed for potential deployment of bottled water), and improvements to the supply of alternate water for schools and care homes including standard plans to support them during supply interruptions.

(c) We have improved our readiness and the mobilisation of our incident response in advance of potential high demand events linked to severe weather including reviewing the personnel available on stand-by, developing a new demand forecasting tool with the Met Office, updating incident management guidance documents and training to incorporate learning from incidents, improving the monitoring and reporting of operational headroom and risks of high demand, purchasing two additional water tankers and five specifically designed trailers that can deliver tanks to harder to reach locations, creating two dedicated fill points in Kent and Sussex for livestock where farmers can collect water free of charge, and organising the delivery of static tanks at livestock farms affected by supply interruptions.

[113] Operational headroom is calculated as the difference between supply and demand, expressed as a percentage of demand. Supply is measured using the "Total Water Available for Use" metric from WRMP24 tables for each resource zone, which accounts for both water exports and imports, while demand is based on daily demand figures by resource zone.

[114] SEW, September 2018, 'Beast from the East' Incident Response – South East Water Action Plan.

(d) Developed a multi-AMP enhancement investment programme (described in Section 2 (Our story) and Section 4 (Costs)) that addresses the root causes and delivers a resilient network for our customers. This will improve our performance significantly over AMP8, including ensuring our network is more resilient to extreme weather and the impact of climate change.

5.18 The enhancement investment necessary to improve our WSI performance, such as service reservoir upgrades, interconnectors and WTW upgrades take a number of years to complete and therefore it is not possible to deliver an *immediate* step-change in performance to the level in Ofwat's FD.

Ofwat's approach to the PCL fails to reflect our company-specific position

5.19 In its FD, Ofwat has failed to reflect the realities of our network configuration, customer behaviour and extreme weather as well as the timing of our enhancement programme. Instead, Ofwat has applied an industry-wide target of 5 minutes for each year of AMP8 without reflecting any of our company-specific circumstances.

5.20 Table 5.2 below shows how Ofwat's PCLs for PR19 and PR24 compare to our actual performance Despite best efforts, our performance over the last 4 years has been significantly above the PCL. As our performance is driven by structural issues that require substantial enhancement expenditure and extreme weather events are expected to continue in the future, Ofwat's targets are unrealistic. They will lead to automatic penalties that ultimately hinder our ability to improve our services and do what is best for customers.

Table 5.2 Comparison of WSI PCLs to actual performance

	PR19				PR24					
	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30
Ofwat FD PCL	00:06:30	00:06:08	00:05:45	00:05:23	00:05:00	00:05:00	00:05:00	00:05:00	00:05:00	00:05:00
SEW Actual Performance	00:31:27	01:12:33	03:02:21	00:44:44						

5.21 Ofwat's approach to the PCL for WSI is at odds with the approach to other PCLs where Ofwat has explicitly adjusted the PCLs to reflect outturn AMP7 performance.[115] In the FD, Ofwat gave the following reasoning:

"It is not realistic to set a forward-looking performance challenge based solely upon PR19 ambition that is not being delivered. […] It would also result in the sector being placed at high likelihood of immediate underperformance from the start of the 2025-30 period. This would also not support delivery of the large investment programme required to deliver improvements for customers and the environment over the 2025-30 period and beyond."[116]

5.22 It is inconsistent for Ofwat to apply this reasoning to many of the wastewater PCLs but not to apply it in relation to WSI.

5.23 In addition, Ofwat applied a company-specific PCL for United Utilities, as it was of the view that United Utilities submitted compelling evidence for regional specific factors affecting their performance and substantial past efforts to improve performance. In Part A of Annex F (Outcomes

115 The adjustment has been applied to total pollution incidents, internal sewer flooding, external sewer flooding, water quality contacts, leakages, main repairs and sewer collapses.

116 Ofwat, December 2024, PR24 Final Determinations: Delivering outcomes for customers and the environment, page 19.

and Water Supply Interruptions) we demonstrate that we have provided evidence on equivalent points.

5.24 In fact, when considering the reality of Ofwat's approach for WSI, it appears that Ofwat has either not followed many of its own principles or has applied them in a way that is not transparent and not consistent. This is demonstrated in Table ANF6 of Annex F "Outcomes and Water Supply Interruptions", which shows how Ofwat's approach to WSI deviates from its own description of its overarching methodology. For example:

(a) Ofwat has not taken into account current performance when setting the PCL.

(b) Ofwat has not taken into account the impact of our enhancement schemes.

(c) Ofwat has not taken into account our company-specific circumstances.

5.25 We have a robust methodology for determining the stretching but achievable performance level. We have undertaken extensive analysis to determine the WSI performance we can deliver, taking account our company-specific circumstances, using the following steps (explained in detail in Part A of Annex F (Outcomes and Water Supply Interruptions)):

(a) We estimate the level of performance that reflects the lack of operational headroom, without extreme weather and AMP8 enhancement schemes. This results in performance of 24.5 minutes per year. This is a direct result of the factors discussed in Part A of Annex F (Outcomes and Water Supply Interruptions).

(b) We add the additional impact of extreme weather at the P50 level. This results in an increase of 9 minutes per year.

(c) We take into account the reduction in interruption minutes as a result of enhancement schemes. This improves our performance by 25.81 minutes by the final year of AMP8.

(d) Using the results from above, we estimate the overall interruptions minutes at the P50 level, resulting from our detailed modelling.

The results of this process are shown in Table 5.3 below.

Table 5.3: SEW calculation of stretching but achievable WSI PCL

	25/26	26/27	27/28	28/29	29/30
A - Interruption minutes reflecting lack of operational headroom (not including extreme weather)	24.45	24.45	24.45	24.45	24.45
B - Additional impact of extreme weather	+9.47	+9.47	+9.47	+9.47	+9.47
Total interruption minutes	33.92	33.92	33.92	33.92	33.92
C - Reduction as a result of delivering our full AMP8 enhancement programme	-0.50	-3.50	-4.41	-9.77	-25.81
D - Total with extreme weather and full AMP8 enhancement programme	**33.42**	**30.42**	**29.51**	**24.15**	**8.11**

Remedy

5.26 In the PR24 FD, Ofwat has set a target of five minutes for every year. Using our expected performance level, indicated by line D in Table 5.3 above, which is equivalent to our P50 expectation, we would incur **£31 million** of automatic penalties across AMP8 (0.75% RoRE) if the current collar of 2% is maintained. This is clearly unacceptable.

5.27 One remedy that we have considered is to ask the CMA to remove the impact of extreme weather from the PCL altogether for two reasons:

(a) Ofwat's funding has not been consistent with the risks it expects us to bear on the WSI PCL. Indeed, there are no standards for water infrastructure design to allow funding to be calibrated against risk.

(b) This is aligned with regulatory precedent in other sectors:

(i) For example, Ofgem removes severe weather events from its Interruptions Incentive Scheme for electricity distribution network operators (DNOs). Ofgem has also introduced uncertainty mechanisms which allow DNOs to recover additional funding in cases of extreme weather. Other infrastructure sectors, including aviation and telecoms, also have exclusions for extreme weather. Ofwat's approach is markedly different from these other regulators.[117]

(ii) This became particularly apparent to us during Strom Eunice where we faced a significant Water Supply Interruption and penalties as a result of multiple power outages while UKPN (the energy network responsible for the assets that failed) did not face any financial penalties.

5.28 However, we recognise that there is considerable work involved in designing extreme weather exclusions. As a result, we propose a practical remedy to set the PCL at a stretching but achievable level. This results in the profile shown in Table 5.4 below.

Table 5.4: Proposed remedy for WSI PCL

Supply interruptions PCL	25/26	26/27	27/28	28/29	29/30
Ofwat's Final Determination	5 minutes	5 minutes	5 minutes	5 minutes	5 minutes
Proposed remedy	33 minutes	30 minutes	29 minutes	24 minutes	8 minutes

5.29 To reach our proposed PCL from our projected performance as shown in line D of Table 5.3 above, we have included an efficiency and ambition stretch. One part of this stretch is that we have accounted for the full benefits of the enhancement scheme from the year of delivery, even though they are due to be delivered at the end of year. Another part is to reflect operational improvements and the lessons learned from our previous interruptions, and partly to demonstrate our ambition for improvement.

5.30 One of the key operational changes is our investment in the availability of tankers that can be used to provide temporary back-up supply to customers experiencing an incident by injecting additional water into service reservoirs. While tankers are an important part of operational resilience, there is a limit to how much tankering can help with severe or wide-spread incidents.

5.31 We are increasing our fleet of tankers to [redacted] and on average these can keep temporary supply up for around [redacted] at a time. If more properties are affected, tankers might be able to provide intermittent supplies that would still be beneficial to customers. In practice, we estimate that tankers reduce our WSI by less than 1%. The capacity limitations of tankering include:

(a) Water has to be available to be moved around by tankers (this may not be the case if we are in a heatwave that affects the whole region).

[117] For a summary of other regulators' approaches see Frontier Economics, 4 October 2022, Managing extreme weather event risk in the regulatory framework.

(b) There can be physical constraints on how many tankers can access the relevant sites, particularly if the incident we are responding to is caused by extreme weather such as a storm.

5.32 If the CMA had concerns about potential outperformance if there is less extreme weather in the outturn than is assumed in our forecast, the CMA could explore whether it would be appropriate for the ODI to be penalty-only, which would fully address such concerns (though note we have not considered such a scenario in our downside risk analysis as set out in Section 7 (Financeability and Investability), and in Annex H (Risk and Financeability)).

The collar is unreasonable

Issue

5.33 The analysis discussed above shows the P50 performance level we can realistically deliver but it does not show that we are exposed to significantly more downside risk than upside potential. This is because more frequent extreme weather events than in the P50 could add more interruptions but benign weather would not have a positive impact. In other words, the risk around WSI is asymmetrical. Without some mitigation for this material asymmetry, then we face a large-scale downside risk that is outside of our control.

5.34 Ofwat's general approach to mitigating risk is to apply a collar on the downside risk:

(a) For the other PCLs which have a collar, Ofwat in general applies a collar of 0.5% of RoRE to cap the penalties and rewards.

(b) On the water side, Ofwat has chosen to set a higher collar for WSI at 1% for the rest of the industry. In the DD Ofwat states that *"This reflects company concerns about a much greater range of underperformance than outperformance on this performance commitment. […] To maintain greater risk balance, while maintaining strong incentives for companies to improve performance, we are setting a collar at -1% RoRE, which is wider than our default collar of 0.5% RoRE."*[118]

(i) It is not clear what Ofwat means by "*maintain greater risk balance*" but given that the collar is higher, Ofwat seems to assume that a bigger incentive is likely to result in better performance. Where performance can be improved as a result of operational changes, this may be true as the costs of addressing an issue may be smaller than the ODI penalty.

(ii) However, in cases where the performance is driven by underlying structural issues that need to be addressed using enhancement schemes, Ofwat's approach simply leads to higher automatic penalties. We have demonstrated in Section 4 (Costs) and Annex G (Enhancement costs) that our performance improvement requires enhancement funding. Our performance in our Western region is excellent, which shows that it is not our operational approach that is the issue. We therefore disagree with Ofwat's approach to the industry-wide collar for WSI.

(c) Ofwat has singled out SEW by applying a collar of 2%. In the FD, Ofwat stated: "*For South East Water we considered setting the collar at a tighter level than -2% RoRE. However, we maintain our position set out at draft determinations that, given their poor performance issues and low resilience to external factors continuing in the latest 2023-24 performance data, a wider collar is required to incentivise the company to make the improvements we expect of* it."[119] Ofwat therefore extends the argument it applied to the whole industry and reasons that poor performance should lead to a wider collar. Importantly, Ofwat explicitly states that the performance issues are due to external factors. Ofwat's approach is

[118] Ofwat, December 2024, PR24 Final Determinations: Delivering outcomes for customers and the environment, page 33.
[119] Ofwat, December 2024, PR24 Final Determinations: South East Water – Outcomes appendix, pages 6 and 7.

therefore contradictory. The magnitude of our resilience issues cannot be resolved via operational changes.

5.35 We therefore conclude that there is no reasonable basis for this punitive differential collar, the result of which is that we are penalised twice as much as other companies in respect of the WSI PCL and four times as much as most companies for most PCLs.

5.36 The combination of the PCL and collar translate into disproportional financial risk, particularly in relation to the impact of extreme weather events. As discussed below in Section 7 (Financeability and investability), and in Annex H (Risk and financeability), under the FD risk package, it is realistic for SEW to achieve a 2% RoRE penalty on supply interruptions alone in a plausible downside scenario, which would result in a multi-notch downgrade and seriously jeopardise SEW's financial resilience.

Remedy

5.37 Ofwat's reasoning that stronger incentives lead to better performance is flawed in areas where enhancement investment is needed to improve performance. Stronger incentives in this case only lead to automatic penalties which reduce our ability to deliver for our customers. This rationale is flawed both at the industry-level and at the company-level.

5.38 We therefore propose that the collar should be set at 0.5% in line with Ofwat's approach to most PCLs. A 0.5% collar is also supported by the following arguments:

(a) Ofwat has set a 0.5% collar for other PCLs that are clearly very important to customers and the environment such as storm overflows and bathing water quality.

(b) When Ofwat calculates the ODI rates, it starts with a RoRE range of 0.6% (which is higher than the standard of 0.5%) as WSI are important to customers. However, the difference is much smaller than the difference in the collars Ofwat applies. While the ODI rate and the collar arguably are different components of the outcomes package, this still raises questions about the consistency of Ofwat's approach. In particular, Ofwat seems to acknowledge that WSI are more important to customers than some other PCLs but not by the magnitude implied by the difference in the collars.

Issue 2: The C-MeX methodology contains regional bias

Issue

5.39 Ofwat's customer measure of experience (C-MeX) is intended to incentivise companies to deliver high-quality customer service and satisfaction. In its current form, company performance is measured relative to a benchmark which is based on the UKCSI all-sector average.

5.40 To be a fair incentive, it has to be the case that there are no underlying regional variations in customer attitudes and behaviours. Ofwat has implicitly made this assumption, but this is not an obviously correct assumption for it to have made. Our view is that regional differences in customer service expectations do exist, in particular that in the south east customers will on average report lower customer satisfaction for the same level of service.

5.41 There are two additional reasons for why customers in the south east of England may not have the same propensity to score water companies:

(a) Companies in the south east have a higher rate of metered customers as they are located in water-stressed areas. Metered customers have a greater propensity to engage with water companies as a result of billing issues compared to unmetered customers.

(b) There is a patchwork of water-only and water and sewerage companies in the south east of England and customers often are not clear about who provides what. There is therefore a greater risk that they provide SEW scores on the basis of other companies' reputations.

5.42 While these factors cannot easily be quantified, they provide important context to the C-MeX scores in the south east.

5.43 To evidence how the propensity to score customer service varies across regions in general, we have analysed UKCSI data. For PR24, Ofwat uses the UKCSI all-sector average in setting the benchmark on which the calculation of the C-MeX PCL is based. Regional data provided to us by the UKCSI shows that the all-sector average for the 'South East' region has been consistently below the overall all-sector average for every UKCSI report since January 2020 (11 reports in total). This is shown in Table 5.5 below.

Table 5.5: UKSCI data for the South East vs nationally

	Jan-20	Jul-20	Jan-21	Jul-21	Jan-22	Jul-22	Jan-23	Jul-23	Jan-24	Jul-24	Jan-25	Average Jan 2020 - Jan 2025
UKCSI overall	**76.9**	**77.0**	**76.8**	**77.4**	**78.4**	**78.4**	**77.7**	**76.6**	**76.0**	**75.8**	**76.1**	**77.0**
South East England	76.2	76.2	76.5	77.2	78.0	78.0	77.4	76.4	75.9	75.5	75.8	**76.6**

5.44 The average difference is 0.4 on a scale of 1 to 100. The picture is consistent across sectors, as for all thirteen sectors included in the UKCSI overall benchmark, the 'South East' region January 2020-January 2025 average is lower than the overall UK average.

5.45 This evidences a propensity on the part of consumers in the south east to rate service quality lower than customers in other regions of the UK. Regional bias in the propensity to score also leads to other regions being unduly rewarded as their scores are not as reflective of their performance as Ofwat assumes.

5.46 The intention of C-MeX is to incentivise improvements in *actual levels* of customer service and satisfaction, and not improvements in *survey scores*. As such, regional biases in the methodology mean that payments are not commensurate with the actual level of performance Ofwat is seeking to incentivise. If this issue is not corrected, we face the prospect of unjustified penalties. Poor performance on customer service incentives may also have a reputational impact, creating additional challenges when engaging with our customers.

Remedy

5.47 To correct the regional bias, the CMA should amend the C-MeX methodology such that we are benchmarked against the all-sector average for the south east, and not the all-sector overall average. This provides a simple and pragmatic way forward that is easy to implement.

Summary of remedies

5.48 To mitigate these specific issues with Ofwat's outcomes package at PR24, we submit that the CMA should implement the following remedies for each of the PCs, as discussed above.

5.49 For **Water Supply Interruptions**, the CMA should set a PCL that is stretching but achievable based on our specific circumstances, instead of the uniform and arbitrary PCL that Ofwat has set. Our proposed PCL is set out in Table 5.6 below. The CMA should also bring our underperformance collar to 0.5% RoRE.

Table 5.6 Proposed WSI remedy

	25/26	26/27	27/28	28/29	29/30
SEW Proposed Remedy PCL	00:33:00	00:30:00	00:29:00	00:26:00	00:08:00
Collar (% of RoRE)	0.5%	0.5%	0.5%	0.5%	0.5%

5.50 While it is our view that the WSI PCL should exclude extreme weather events as a matter of principle, we recognise that this may not be feasible for the CMA in the context of a redetermination process. Setting a more appropriate PCL and collar offer a practical solution which mitigates some of the excessive downside risk in the FD. If the CMA had concerns about potential outperformance if there is less extreme weather in the outturn than is assumed in our forecast, the CMA could explore whether it would be appropriate for the ODI to be penalty-only, which would fully address such concerns (though note we have not considered such a scenario in our downside risk analysis as set out in Section 7 (Financeability and Investability), and in Annex H (Risk and Financeability)).

5.51 For **C-MeX**, the CMA should modify the calculation of company performance such that any inherent regional biases are removed. This could be achieved by measuring our performance relative to the UKCSI all-sector average for the south east region, as opposed to the all-sector national average.

5.52 For **NHH Voids**, as explained further in Annex I (PR19 reconciliation: NHH Voids), the CMA should remove the associated downward adjustment to our future revenues (specifically the underperformance payments for the PR19 NHH voids ODI) that Ofwat applied as part of its PR24 FD.

6 Risk and return

There is a material imbalance in Ofwat's FD package. Risk is increasing and the allowed return is not fair or commensurate with the returns that equity investors can obtain on comparable investment opportunities elsewhere.

The CMA should adopt the following approach:

(i) Revisit the calculation of the Cost of Equity, taking into account the evidence set out in the Cost of Capital Report, and select a point estimate which is at least 6.32%.

(ii) Revisit the calculation of the Cost of Debt, taking into account the evidence set out in the Cost of Capital Report, and implement an uplift of 56bps to the Cost of Debt, from Ofwat PR24 FD allowance of 3.15% to 3.71%.

(iii) Aim up on the Cost of Equity by 44bps to reflect otherwise unmitigated skew on the PR24 FD's outcomes package.

(iv) Allow SEW a Company Specific Adjustment (CSA) on the Cost of Debt which reflects SEW's status as a small company that issues debt relatively infrequently.

Overview

6.1 The return on capital is an important component part in the calculation of our customers' bills. As we explained in Section 2 (Our story), the regulatory framework allows consumers to pay for new investments in water infrastructure in instalments over the life of the built assets, rather than in one lump sum upfront. This can happen because we are able to use providers of both equity capital and debt finance to bridge the gap between: (i) the monies spent on new pipes, upgrades to treatment works and other capital projects, and (ii) monies coming in from customer charges. In return, investors expect fair compensation for the financial risks they take.

6.2 Nobody is forced to put money into water companies. Going into the 2025-30 regulatory period, there are thousands of other places that investors can put their capital to work, and many of these opportunities are offering historically attractive rates of return following the step up in global interest rates that we have seen over the last 2-3 years. It follows that in order for us to maintain access to investor capital, and in order for the profiling of costs out over time to continue, Ofwat's price controls must put us in a position where we are capable of offering a return that is commensurate with the returns that investors can earn on other comparable investments.

6.3 One of the key questions for the CMA panel is: what is this rate of return? The allowed return should be no higher than is needed, so as to avoid loading unnecessary cost onto bills. But, as the CMA made clear in its PR19 decision, it is also not in customers' interests for the allowed return to be set too low. This would risk causing an exit of capital from the industry.

Ofwat's PR24 allowed return was inconsistent with returns available elsewhere

6.4 Ofwat's calibrations of the PR24 allowed return caused us considerable concern.

6.5 Ofwat set the allowed return on equity capital at CPIH + 5.1%. This is the equivalent of just 65 basis points above the CMA's PR19 return, despite a 400-500 basis points increase in the level of interest rates in the last 4-5 years and despite a clear sense across the investor community

that the water industry has become a more risky place to invest in than it was in the past.[120] A CPIH + 5.1% rate of return converts to an expected, all-in nominal return of between 7.0% and 7.5%.

6.6 The table below puts Ofwat's PR24 return on equity next to the observable rates of return that an investor can currently obtain from competing assets. A ~2 percentage point premium over the risk-free rate (or only ~1 percentage point above the cost of debt) represents an exceptionally narrow margin for the significant risks equity investors assume in relation to expenditure, investment, delivery, and performance.

Table 6.1 – Comparison of Ofwat PR24 return on equity with observable returns on government and corporate bonds

	Yield / return[121]
20-year UK gilts	5.10%
10+ year A rated corporate bonds	5.80%
10+ year BBB rated corporate bonds	6.20%
Ofwat PR24 return on equity	CPIH + 5.1%

6.7 When our board looked inside and outside the industry and asked itself whether it thought a return of this magnitude would be viewed as an acceptable return for equity investors, and so underpin and reinforce long-term investor commitment to our sector, it was forced to conclude it would not. As such, we do not consider Ofwat satisfied its duties.[122]

6.8 We invite the CMA panel to conduct the same self-assessment. A useful way to frame the key question in this part of the CMA's price review is: what rate of return would cause you to choose to put your money into the water industry given the returns that are currently on offer elsewhere?

6.9 Ofwat separately set the allowed cost of debt below our actual interest costs. Ofwat has a long-standing policy of providing the same percentage allowance to all but the smallest companies, which inevitably benefits some companies and disadvantages others, given the impossibility that multiple companies borrowing at different times and in different ways could ultimately arrive at exactly the same weighted average interest rate. We asked ourselves whether this was a penalty that we ought to bear given the infrequent opportunities that we have had to raise debt in the past. We concluded that it was not.

6.10 We request a fresh opinion from the CMA on this matter based on the CMA's assessment of the natural variance that it would expect to see – and tolerate – in an efficient water-only company's costs versus the industry median.

Further detail

6.11 The CMA will ultimately be required to arrive at a point estimate of our cost of capital.[123] The allowed return can be calculated as a weighted average of the cost of equity capital and the cost of debt, as follows.

120 KPMG, March 2025, Estimating the Cost of Capital for PR24, pages 9 to 10.
121 Source: Bank of England and S&P Global IHS Markit as of 3 January 2025.
122 See Annex B (Legal and Regulatory Framework). Of particular concern is Ofwat's failure to satisfy its finance duty. However, we also consider that setting the allowed return too low does not further the consumer objective, the resilience objective or Ofwat's growth duty. Moreover, it is not consistent with enabling the delivery of the four strategic priorities identified in Defra, 28 March 2022, The government's strategic priorities for Ofwat.
123 As per Ofwat's PR24 methodology, the cost of new debt feeding into the CMA's calculation can be indexed in line with changes in interest rates.

Allowed return on equity

6.12 The CMA has historically used the capital asset pricing model (**CAPM**) to estimate the cost of equity capital. We agree that this is the correct starting lens. CAPM says that investors that put money into equity investments will require a return that is strictly higher than the return on "riskless" assets. The required premium will be a function of the return that investors expect to earn by investing in a market portfolio of shares and an industry-specific scaling factor, beta, that reflects the riskiness of our industry i.e.:

Required return on equity = rfr + beta x (rm – rfr)

where *rfr* is the risk-free rate and *rm* is the expected market return.

6.13 The CMA produced a comprehensive analysis of each of the input values in the above formula as recently as 2021 as part of its PR19 decision. The CMA's role, as we see it, will be to update this body of work in light of the change in interest rates and the change in investors' views on risk.

Risk-free rate

6.14 There are a number of possible proxy measures for the risk-free rate. In its March 2021 report, the CMA chose not to place sole weight on one of these measures to the exclusion of all other possible measures. In particular, the CMA expressed considerable reservations about placing exclusive reliance on atypically low index-linked gilt (**ILG**) yields due to evidence that the ILG rate is not a rate that even the highest-quality borrowers in the country, other than the government, are able to access.

6.15 Due to these concerns, the CMA found that it was appropriate to take reference from a total of three different sources. Data as at the start of 2025 shows that the ILG rate remains significantly lower than these other available estimates of the return on (near) zero-risk assets. We are therefore of the opinion that the points of principle that the CMA laid down in 2021 still hold true today and that the CMA can safely proceed in this area to update its previous calculations so as to reflect data as at 2025, rather than as at 2020.

Beta

6.16 The CMA's PR19 estimate of beta was based on empirical observations of the two then-listed, pure-play water companies, Severn Trent and United Utilities. Since the completion of the CMA's work, Pennon (the owner for South West Water, Bristol Water and SES Water) has emerged as a third pure-play company following the divestment of its waste disposal business in 2020. We had expected that Ofwat would expand its comparator set in PR24 to include data from all three listed companies.

6.17 Despite repeated industry submissions, Ofwat excluded Pennon's beta from PR24 calculations. A comprehensive evaluation incorporating all available data will produce a more reliable measure of water sector risk exposure. Accordingly, we would encourage the CMA to include Pennon's data as it carries out its work.

6.18 When undertaking this work, one of the key issues will be how well backward-looking measures of the covariance that there has been between water company valuations and the value of the stock market as a whole serve as an indicator for the covariances that investors will expect to see during the 2025-30 regulatory period and beyond. One of the complicating factors is the question of how much, if any, weight to place on Covid-19 period data. More fundamentally, as we explain in Section 2 (Our story) and Annex D (Supporting information), there has been material change in the water industry since the CMA last looked at the sector:

(a) there has been a step change in statutory and non-statutory investment requirements, leading to large increases in the £m amount of capital expenditure that companies are managing, exposing companies to increased capital delivery risks;

(b) the bigger capital programmes have, in turn, limited the net distributions that companies are able to make and created requirements for new equity injections;

(c) the sense that these investments will typically generate stable and predictable long-term returns for equity investors has been upended by the unprecedented RoRE under-performance that investors have had to deal with since PR19 and by the fright that Thames Water's resultant financial problems has caused; and

(d) to add further uncertainty for investors, the regulation of the sector has become perceptibly more uneven, causing both Moody's and Standard and Poor's to downgrade their ratings of the quality and supportiveness of the regulatory regime.

6.19 All of these things point to heightened investor exposure to systematic risk and/or heightened perceptions of investor exposure to systematic risk. As evidence of this, it is instructive to look at the most recent surveys of investors carried out by the likes of the Global Infrastructure Investors Association,[124] Barclays Capital[125] and Oxera,[126] each of which highlights a stark downward turn in investor sentiment towards the England & Wales water industry in comparison to similar sectors elsewhere.

6.20 All other things being equal, this ought to mean that our forward-looking beta has increased since the CMA's PR19 assessment. It was a considerable surprise to us, therefore, that Ofwat chose in its PR24 to make a small downward adjustment to its PR19 beta. We think this was wrong in quantitative terms (see, for example, the comments above about the exclusion of Pennon data) and wrong in a qualitative sense.

6.21 There are ways that the CMA can ensure that it makes appropriate allowance for changes in the sector's risk profile. On the quantitative side, the CMA can widen the comparator set to bring in data from companies like National Grid that have encountered a step up in investment requirements several years earlier than water companies (in addition to including Pennon, for the reasons given above). In qualitative terms, the CMA can ensure that its PR24 estimate is positioned logically against previously used beta values (e.g. the PR19 beta) and against the betas that are being used currently in other comparator sectors (e.g. the RIIO-3 beta for energy network companies).

Expected market return

6.22 The CMA will recall that considerable effort was expended before and during its PR19 inquiry to get a read on the returns that investors have historically taken from, or historically expected to obtain from, UK stock market investments. After further refinements to the analysis since the completion of the CMA's PR19 work, there is now a good measure of agreement among regulators, companies and independent experts that the appropriate benchmark to use is just below 7% (in real, CPIH-stripped terms).

6.23 The question this time is therefore less about how to process historical data and much more about whether it is appropriate to drop the (generally agreed) long-term historical benchmark into the CAPM calculation. This question is important in the context of the PR24 review because one would expect a priori that the switch up to a 'higher-for-longer' interest outlook will have resulted in a step up in expected returns on all asset classes, including stock market investments. It follows that it may be necessary to 'aim up' from historical averages in some way on the expected market return in order to ensure that the returns that water companies are able to offer to investors are competitive against the returns that are available on rival investment options.

6.24 We invite the CMA to consider how much of a step up is needed to ensure that there is this kind of level playing field between the water industry and other investment opportunities. One option would be to explicitly aim up from a long-term historical benchmark when selecting a value for the expected market return. The alternative might be to employ cross-checks towards the final stages

124 GIIA, 2024, Infrastructure Pulse, page 7.
125 Barclays, 14 November 2024, 'Rating agencies and investor survey: all about contagion'.
126 Oxera, October 2024, PR24 Investor Engagement Report, page 8.

of the cost of equity calculation, with a view to ensuring that the allowed return, in aggregate, is positioned logically in relation to returns on competing investments.

Cross-checks

6.25 The simplest cross-check that the CMA can make is to compare estimates of required equity returns to the observable returns on government and corporate bonds. This is set out in Table 6.1 above. As at January 2025, investors could lock in rates of return of:

(a) 20-year gilts = 5.1%;

(b) 10+ year A rated corporate bonds = 5.8%;

(c) 10+ year BBB rated corporate bonds = 6.2%.

6.26 It should be self-evident that the PR24 allowed return on equity must be positioned a meaningful distance above these benchmarks if investors are going to be persuaded that it is worth taking on the equity risks that ownership of water company shares entails. (NB: Ofwat's allowed return of CPIH + 5.1%, equivalent to an expected all-in, nominal return of 7.0% to 7.5% clearly did not pass this test given the close proximity to gilt yields (only circa 200 basis points) and investment-grade bond yields (only circa 100 basis points).)

6.27 Other possible cross-checks include:

(a) Market-to-asset ratios – the CMA rightly expressed caution in its PR19 decision about the inferences one should draw from the level of company's share prices. However, evidence that one or more of the better-regarded water companies are changing hands at prices below RCV would constitute a strong directional signal about the movement that there needs to be in permitted returns.

(b) Credit metrics – the CMA identified that the assessment of financeability (covered in more detail in Section 7 (Financeability and Investability)) acts as a valuable cross-check on a CAPM cost of equity calculation. If the CMA finds that a particular level of equity return results in interest cover that is not compatible with a Baa1/BBB+ Investment-grade credit rating, this would be strong evidence that the proposed equity return has been calculated incorrectly.

(c) Multi-factor models – we said at paragraph 6.12 above that CAPM should be the starting lens in any discussion about the cost of equity. It should not be the only lens, however. There exist a range of other asset pricing models which would have stronger empirical performance than the CAPM that the CMA can cross-check to in its work. We consider that weight should be attached to evidence from these alternative models which points to higher or lower required returns.

(d) Bias – it is also important to estimate CoE in a way that minimises bias in order to ensure an appropriate balance between setting a return which attracts equity capital and serving the best interest of customers. Bias in the estimation process can have significant consequences. For example, a downward bias could risk allowed returns not being sufficient to attract equity capital, while an upward bias would not serve the best interests of customers. Minimising bias therefore requires a balanced interpretation of the available evidence.[127]

Selection of point estimate

6.28 Notwithstanding the valuable new perspectives that the CMA will be able to bring to the table over the coming months, there will inevitably be a degree of uncertainty at the end of the process about

[127] KPMG's report "Assessing the Balance of Evidence in PR24 FD CoE estimate" (2025) provides further details of the analysis it has undertaken to assess the extent to which the PR24 FD methodology reflects a balanced evaluation of evidence.

the precise value of the cost of equity. The CMA's PR19 report contained a comprehensive discussion of the factors that should influence the selection of a point estimate from a computed range. We encourage the CMA to refresh this analysis, weighing the costs there are at the current time of setting the allowed return too low vs too high. We wish to make two particular observations upfront:

(a) First, the CMA will recall that its original proposal in its PR19 draft decision was that it was appropriate to aim up by 50 basis points from the mid-point of the calculated cost of equity range. In its final decision, the CMA halved this amount, principally on the grounds that there was limited corroboration at the time for the view that returns in the sector were fundamentally too low.[128] The circumstances this time around are materially different, as evidenced at paragraphs 6.22 to 6.24 above, such that instincts should probably be that the appropriate positioning of the PR24 return will likely be closer to the CMA's PR19 draft decision positioning than the final decision positioning.

(b) Second, we set out in Section 5 (Outcomes) and Annex F (Outcomes and Water Supply Interruptions) that we have significant concerns about asymmetry in our ODI package. The CMA can address this asymmetry by making changes to PCL and ODI arrangements. Alternatively, the CMA can do what it did in PR19 and provide for an explicit uplift in the allowed return to offset expected ODI losses.

CAPM range

6.29 To assist the CMA as it works through the issues that we have outlined under the preceding headings, we, along with three of the other disputing companies, commissioned the Cost of Capital Report.

6.30 The conclusion that KPMG reaches at the end of its work is that the required return on equity for the 2025-30 period likely lies in the range 5.60% to 6.04%.

Table 6.2: KPMG cost of equity range

	KPMG
Gearing	55%
Risk-free rate	2.33% to 2.85%
Expected market return	6.93%
Unlevered beta	0.32 to 0.36
Debt beta	0.10
Equity beta	0.71 to 0.78
Cost of equity (range)	5.60% to 6.04%
Aim up from mid-point	0.5%
Cost of equity	6.32%

6.31 We consider the KPMG work to be a helpful input to the conversations that we will need to have with the CMA and Ofwat over the coming months. Our view, in particular, is that KPMG has set out a more balanced and thorough analysis than Ofwat when triangulating between the line-by-line analysis of risk-free rate, beta, expected market return, etc. and the top-down sense-checks that there need to be on the overall estimate of required returns.

[128] CMA, 17 March 2021, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report, paragraphs 9.1389 and 9.1390.

Allowed cost of debt

6.32 The allowed cost of debt is made of up of separate allowances for the cost of embedded debt, the cost of new debt and ancillary debt-related costs.

6.33 The Cost of Capital report reviews the inputs feeding into each part of the calculation and identifies a number of self-contained issues for the CMA to address as regards: the treatment of inflation swaps; the cost of carry; CPIH/RPI basis risk; and the percentage weights for new and embedded debt. We refer the CMA at this point directly to Section 11 of the Cost of Capital Report.

6.34 Ofwat's approach in PR24, like the CMA's approach in PR19, involves providing a single, common cost of debt allowance to all but the smallest water-only companies. We accept that the CMA panel looked at the merits of this one-size-fits-all approach five years ago when one of the large WaSCs, Yorkshire Water, sought funding for its higher-than-average cost of debt. However, we request that the PR24 panel considers afresh whether an industry-average approach is appropriate in South East Water's different circumstances, as a relatively small company that issues debt relatively infrequently.

6.35 The main observations that we would like to make upfront on this point are as follows.

(a) There are a number of factors that shape companies' efficiently incurred interest costs. In particular, whether looking back or looking forward, it will be observed that: (i) market interest rates vary over time; and (ii) companies inevitably have raised / will raise debt through the ups and downs of the interest cycle in different amounts, at different times and at different tenors.

(b) This makes it is impossible to envisage how multiple efficiently run water companies could ever converge on exactly the same average interest rate. Instead, it should be expected that there will inevitably be a spread of costs across the sector at any given point in time. (Note that this makes interest costs fundamentally different from other costs, where it often is possible to think of a single efficient level of costs for firms with the same basic characteristics.)

(c) As a relatively small company compared to the large WaSCs, the variance in SEW's interest costs was historically higher than that of other firms. This is because SEW's debt financing requirement historically reached a benchmark market size relatively infrequently, causing it to borrow relatively infrequently. As an infrequent issuer, SEW therefore faced heightened risk that it would end up borrowing in years when interest rates are particularly high or particularly low relative to the mean over a longer time horizon. By comparison, larger water companies, as more frequent visitors to the market, faced less potential for deviation in interest costs relative to medium-term historical averages.

6.36 The question we therefore have for the CMA, which is fundamentally different from the question that Yorkshire Water asked five years ago, is: is it fair and proportionate that SEW, as an infrequent issuer historically,[129] should be exposed to the consequences of higher interest cost variance without some form of offsetting compensation for the resulting risk that shareholders bear around cost of debt out- and under-performance?

6.37 In our submissions to Ofwat, we did not request that our actual interest costs should be funded in full. Instead, our suggestion was that the out-turn consequences of our relatively infrequent issuance should be shared with customers. When one compares Ofwat's approach to totex and Ofwat's approach to the cost of debt, it is striking that the regulator considers it right that companies should be permitted to share all out- and under-performance on totex 50:50 with customers, while simultaneously providing for 0:100 sharing of out- and under-performance on interest costs. This is even more the case when one considers that totex under-performance can

[129] We expect – given the scale of our capital programme across AMP8 – to be a more frequent issuer going forwards. In this context, we are seeking our higher risk arising from infrequent issuance in the past to be priced and do not propose an adjustment for risk on new debt issuance in AMP8. The CSA we propose is applied to the cost of embedded debt only, with no adjustment to the cost of new debt for company specific factors

be a consequence of inefficiency, while variation in the infrequent issuer's cost of debt will typically be the result of factors that lie outside of the company's control.

6.38 We therefore consider that there is sound economic and regulatory logic for the CMA providing in its determination for a sharing of variations in infrequent issuers' interest costs versus the industry median.

6.39 The evidence to support this position is developed further in the Cost of Capital Report.

Conclusion

6.40 Financial capital is no different from other essential business inputs – such as labour, concrete, plastics, and power. In other aspects of price control, there is no debate over whether customers should cover the market rate for wages and materials. The same principle must apply to financial capital.

6.41 Lenders and equity providers operate in a global market. If allowed returns do not reflect market conditions, investment in the sector will decline – ultimately harming consumers through reduced infrastructure investment and weaker service resilience.

7 Financeability and investability

Ofwat's PR24 FD is not financeable or investable. The allowed return is objectively too low for equity investors and undermines debt financing. There is insufficient financial headroom to allow SEW to manage risk.

This leaves unacceptable water security risks for our customers in the short and longer term and undermines our plan to re-establish headroom, operational flexibility and resilience, particularly in our Kent and Sussex regions.

The CMA should adopt the following approach:

(i) Change the ASM thresholds to reflect a ±2.00% "lower" threshold at 50% sharing and ±3.00% "upper" threshold at 90% sharing.

(ii) Remove the ±50bps OAM deadband.

Overview

7.1 The cost of the investment that we are planning to carry out in the next five years will be recovered from customers over a period of several decades. This requires us to raise a significant amount of new capital to bridge the gap between money being spent on schemes and money coming in from customers' bills. We will also have to continue to service and refinance the capital that we have previously taken from investors for investments made in earlier regulatory periods.

7.2 Our ability to access the financing that we need depends on two main factors. First, the allowed return must be comparable to the returns that investors can currently obtain elsewhere from competing investments with a similar risk profile. Second, cashflows during AMP8 must be sufficient to enable us to obtain and maintain a solid investment-grade credit rating and meet key rating thresholds as well as permit equity investors to receive a reasonable return.

7.3 We can say that a company is not 'financeable' if: (i) equity investors cannot earn forward-looking returns equivalent to those available from assets of similar risk; (ii) the available cashflows during the upcoming five-year period will be deemed insufficient to permit the company to maintain an adequate credit rating, particularly with regard to interest coverage; or (iii) the company is not resilient to plausible downside scenarios.

7.4 As the CMA has previously recognised, this requires an in-the-round assessment.[130] The financeability test is an overall cross-check of the regulatory determination when taken as a whole. It arises out of Ofwat's duty to secure that water companies can – through securing reasonable returns on their capital – finance the proper undertaking of their statutory functions.[131] This needs to take account of the real-world context in which the determination is made.

7.5 The conclusion our Board reached when it reviewed the FD in the round is that both the allowed return and the level of cashflows over a five-year period impede – rather than support – our access to financial capital and give us less financial resilience than we ought to have in the face of possible future shocks. As such, it was not in the interests of customers for us to accept the FD.

7.6 We therefore request that the CMA reassess these matters afresh, fixing the identified flaws in Ofwat's approach. To assist the CMA in this assessment, we outline in this Section where Ofwat

130 CMA, 17 March 2021, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report, paragraph 10.73.

131 See Annex B (Legal and Regulatory Framework). Other aspects of the legal framework which are highly relevant are the resilience objective and Ofwat's growth duty. The outcomes which it likely gives rise to are also fundamentally inconsistent with the consumer objective.

went wrong in its FD. We then suggest remedial actions which the CMA could take to address our financeability concerns at the end of the Section.

Why Ofwat's approach is flawed

Allowed return

7.7 We explained in Section 6 (Risk and return) why we consider that Ofwat set the allowed return below our cost of capital.

7.8 The under-provision of return directly impacts our financeability because unduly low incoming cashflows depress key financial ratios, weakening our credit quality in the eyes of lenders and rating agencies. It also cannot safely be assumed that we will be able to raise the equity finance that we will require in the next five years. This, in turn, places further pressure on our ratios and ratings because, during a period with very large investment requirements, the attainment of a solid investment-grade credit rating is inextricably linked to the confidence that lenders and rating agencies have about our ability to raise new equity capital.

7.9 The correct calibration of the allowed return is therefore an essential pre-requisite to both our debt financeability and our equity financeability.

Risk

7.10 When assessing our creditworthiness, lenders and rating agencies will be cognisant of the full range of possible states of the world and associated financial out-turns that a company might plausibly encounter during AMP8.

7.11 One way of collating the potential financial impacts that will flow from the different operational and financial risks that we are managing is to construct probability distributions for future out-turn return on regulatory equity (**RoRE**). We set out in Annex H (Risk and Financeability) a depiction of the RoRE ranges that we think a notional WoC operating in our region was looking at following receipt of Ofwat's FD. The results are summarised in table 7.1 below.

Table 7.1 - Risk exposure of a notional WoC operating in our region

	P10	P50	P90
Totex	-4.81%	-2.40%	0.35%
Retail	-1.21%	-0.20%	0.78%
DPC	-0.13%	0.00%	0.00%
ODIs & MeXes	-3.62%	-2.01%	-0.03%
Financing	-2.04%	-0.07%	1.93%
Revenue	-0.05%	-0.03%	0.00%
RoRE (simulated)	**-8.19%**	**-4.46%**	**-0.75%**

7.12 The table shows an expected P50 under-performance as a result of Ofwat's miscalibration of totex allowances, PCLs/ODIs and the allowed cost of debt (NB: P50 refers to the 50th percentile in the probability distribution). The analysis also shows a c. +/- 350bps basis points range around the central case forecast at a P10 and P90 level of confidence.

7.13 This corroborates the view that we expressed upfront in Section 1 (Executive Summary), that Ofwat's FD puts us in a position where we need everything to 'go right' in the next five years in

order to make a success of Ofwat's PR24 FD. Just as importantly, it also shows that the financial downsides that we are exposed to are potentially very severe, with equity investors potentially able to lose all of their real returns – and more – in the event of plausible downside events.

Ofwat's approach to assessing financeability

7.14 Ofwat assessed whether, under the FD, companies with a notional financing structure (comprising a starting mix of 55% debt and 45% equity) would be able to achieve a Baa1/BBB+ rating. Ofwat considers this provides adequate levels of headroom for companies to cope with most cost shocks and to maintain access to debt and equity finance at reasonable levels on an ongoing basis.[132]

7.15 We agree that it is correct to assess financeability on a notional basis. But we consider that Ofwat's PR24 analysis was flawed in multiple ways. Specifically:

(a) Ofwat's conclusion that all companies pass debt financeability tests was dependent on its assertion that companies can raise a collective £12.7 billion of new equity, which was neither evidenced nor credible in light of the issues identified in Section 6 (Risk and return);

(b) there were errors in Ofwat's modelling assumptions afflicting, in particular, Ofwat's modelling of the notional company's expected ODI penalties and the profile of the notional company's interest payments. These errors are set out in more detail in Annex H (Risk and Financeability);

(c) Ofwat did not adequately stress test a company's ability to maintain a Baa1/BBB+ rating in the face of potential downside scenarios; and

(d) Ofwat failed to consider the direct effect its determinations would have on sector-wide rating thresholds. All three rating agencies have tightened their rating thresholds to reflect reduced "*stability and predictability of the regulatory framework*" (Moody's), a reduction in Ofwat's "*regulatory advantage*" (S&P) or increasing business risk (Fitch).

7.16 Further detail on each of these points is provided in Annex H (Risk and Financeability). We summarise the implications of Ofwat's errors below.

Context: rating agencies and their concerns

7.17 The CMA will be aware of the concerns raised by each of the three main credit rating agencies about the overall level of risk in the water sector, the regulatory framework and Ofwat's application of it. Each of the main agencies has, at different points since November 2024, downgraded its assessments of water companies' intrinsic credit quality. In particular:

(a) in November 2024, Moody's downgraded its assessment of the stability and predictability of the regulatory environment;

(b) in February 2025, S&P Global Ratings (S&P) downgraded its assessment of the sector's regulatory advantage from 'strong' to 'strong/adequate' and significantly increased the cash flow required to achieve a given rating level.

7.18 Rating agencies have also downgraded their assessment of SEW specifically in light of Ofwat's determinations. In November 2024, citing the risk of unfunded enhancement expenditure and unachievable performance commitments, Moody's downgraded its assessment of SEW's ability to recover its costs from 'A' to 'Baa' and its rating from Baa2 to Baa3, and placed the rating under review for further downgrade.

7.19 After shareholders contributed £75 million of new equity and certain debt maturities were extended, Moody's and S&P affirmed the ratings with a negative outlook in December 2024,

[132] Ofwat, December 2024, PR24 Final Determinations: Aligning risk and return, page 38.

indicating that pressure on the rating remained, but that further downgrade had, for the time being, been avoided.

7.20 More recently in February and following the PR24 FDs, S&P lowered SEW's rating to BBB- from BBB and placed the rating on CreditWatch negative, highlighting *"The higher risk is reflective of the overall final determination package for AMP8 coupled with the uncertainties associated with the execution of its business plan under such conditions and a track record of weak supply interruptions performance during AMP7."*[133]

7.21 In March, SEW's rating has been further reaffirmed with a negative outlook by Moody's. Moody's explained that SEW *"received one of the most challenging determinations in the sector"* and that it expects *"challenges to persist" over AMP8 "given the company's challenging determination".* It stated that *"South East Water's sizeable investment programme will place further upwards pressure on leverage, absent action to protect credit quality or the Competition and Markets Authority (CMA) making material changes to the company's regulatory settlement for AMP8."* Further, Moody's explained that its ratings scorecard *"indicates a Ba1/Ba3 outcome for our forward view, which is one to three notches below the actual assigned rating of Baa3."* It noted that this is due to its forward view factoring its *"expectation of operational underperformance in AMP8 under the current regulatory settlement"*.[134]

The FD does not allow a notional company operating in our region to achieve the target credit rating

7.22 KPMG assisted us to prepare analysis to test whether a notional WoC operating in our region, reflective of SEW's specific characteristics and risk exposure, would be financeable under Ofwat's FD. Its ability to obtain a Baa1/BBB+ rating under Ofwat's FD was tested in two stages:

(a) First, the analysis assessed whether the notional company could be expected to achieve a Baa1/BBB+ target credit rating under an appropriate notional financial structure (55% net debt/RCV with 33% of opening debt linked to CPIH), with no RoRE over/underperformance and assuming that the notional company is able to raise equity capital as set out in Ofwat's FD.

(b) Second, it then tested the notional company's financial position under the estimated P50 performance. This includes an assumption that the notional company cannot raise equity capital (due to the award of an insufficient rate of return) and can distribute dividends only by maintaining a minimum rating of Baa2/BBB (stable outlook), consistent with the financial resilience licence provisions. This is consistent with the position set out in Section 6 (Risk and return) where we explain that the allowed return on equity capital is too low. Debt financeability constraints cannot be assumed to be resolved by equity-raising, not least due to fundamental concerns with regard to equity financeability.

7.23 In order to obtain a Baa1/BBB+ credit rating, a water company will normally need to exhibit: adjusted interest cover of at least 1.6x (Moody's); FFO / net debt of at least 11% (S&P); and cash PMICR[135] of at least 1.7x (Fitch).

7.24 The analysis shows that even under Ofwat's FD assumptions the notional company cannot achieve the Baa1/BBB+ target credit rating for Fitch and S&P and has very limited financial headroom on the Moody's AICR.

7.25 The notional company's financeability challenge then becomes more acute when considering expected (i.e. P50) performance. As shown in Figure 7.1 below, if the notional company performs in line with P50 totex, ODIs, etc., it faces downgrading below investment grade with all credit rating agencies, calling into question its ability to satisfy Condition P of SEW's licence, which requires it to maintain two investment grade credit ratings. The impact on credit ratings is

133 S&P, 18 February 2025, U.K. Water Regulatory Framework Support, Low Financial Flexibility In Coming Regulatory Period Drive Rating Actions, page 22.

134 Moody's, 4 March 2025, Rating Action: Moody's Ratings maintains negative outlook on South East Water; affirms Baa3 ratings.

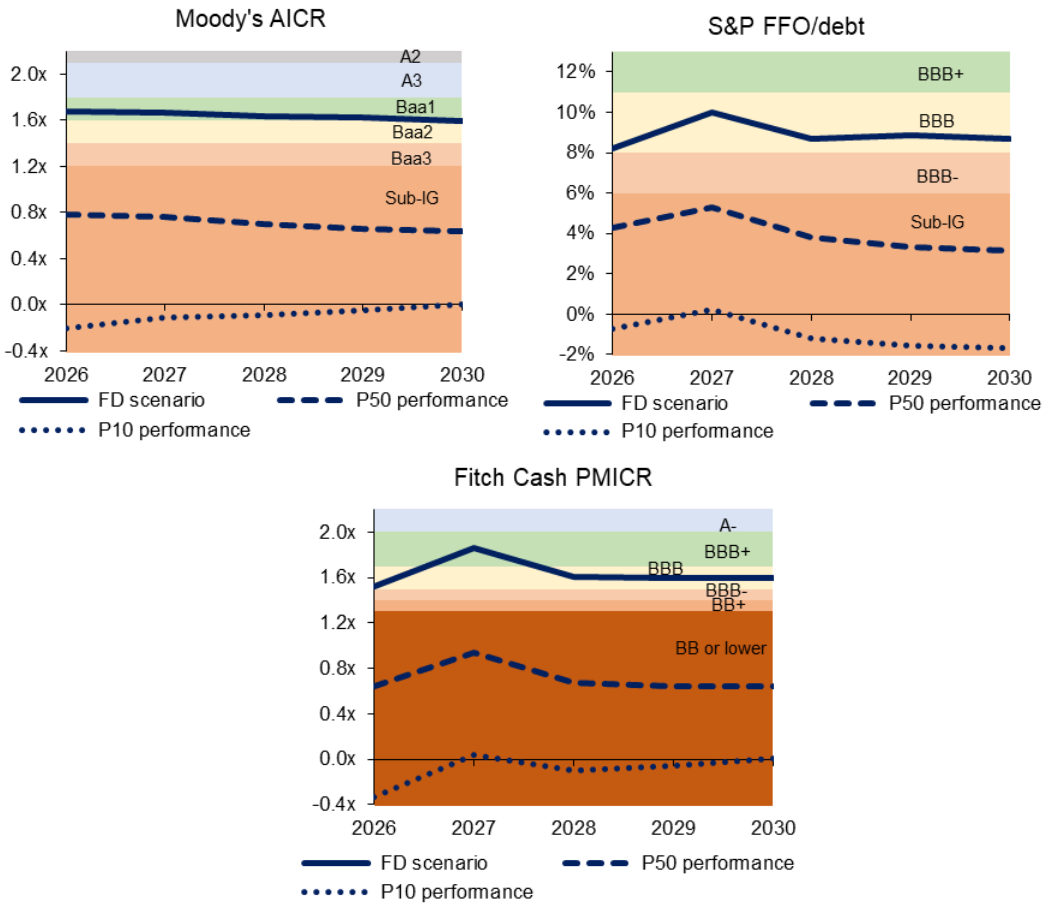
135 Post-maintenance interest cover ratio.

particularly severe as the notional company will bear the cash flow impact of totex overspend in full during AMP8, while benefitting from the cost sharing mechanism only at the end of the control period. The analysis indicates a downwards trend in performance over AMP8, which is expected all else equal to continue into AMPs 9 and 10 as more expensive new debt replaces cheaper embedded debt on the notional company balance sheet. This corroborates that current levels of return as set out in the FD are not sustainable and will not be sufficient to support achieving the target rating.

7.26 These prospective credit ratings, in turn, act as a further reason to doubt that the equity investment that Ofwat includes in its modelling for the notional company would actually be forthcoming. Accordingly, the P50 case in the table assumes no new equity capital in AMP8 and could potentially provide the most accurate characterisation of the notional company's position under Ofwat's FD.

7.27 The positioning of the notional company in the two scenarios is illustrated graphically in the charts below.

Figure 7.1 - Annual credit metrics under Ofwat's FDs with modified financial structure and under the P50 and P10 performance scenarios



A notional company operating in our region is not resilient to severe downside scenarios which indicates that the risk exposure implied by the FD is excessive

7.28 The P10 scenario for a notional WoC operating in our region puts at risk the full allowed return on equity and exposes investors to a negative return.

7.29 In a P10 downside scenario the notional company is unable to generate positive operating cash flows and therefore achieves credit metrics below the investment grade threshold with all three rating agencies. This is shown in Figure 7.1 above.

7.30 The prospect for a notional company operating in SEW's particular supply area to fail the financial resilience test requirement is very plausible. For example, it is realistic for SEW to achieve a 2% penalty on supply interruptions alone in a plausible downside scenario, which would result in a multi-notch downgrade and seriously jeopardise SEW's financial resilience. The notional company is not therefore resilient to severe but plausible downside scenarios implied by the FD and could face the real prospect of rating downgrades and increasing financing costs well above the allowed cost of debt. This scale of plausible downside risk exceeds the level of risk in other regulated sectors and therefore is also a material factor for investors considering investing new equity capital in the notional company.

Financeability conclusions

7.31 The preceding charts and tables, in combination, paint a picture of a company that would likely not be able to obtain or maintain a solid investment-grade credit rating and which would face significant difficulties accessing new equity capital.

7.32 As such, Ofwat cannot be said to have discharged its duty to secure that SEW can finance its activities.

Our request to the CMA

7.33 Alongside the requested remedies to address the risk and return imbalances, we request that the CMA adopt a robust approach to financeability and financial resilience testing to verify that a notional company in the SEW region is able to achieve the Baa1/BBB+ target credit rating and maintain a minimum Baa2/BBB rating under downside scenarios, allowing it to access debt financing at a cost commensurate with an appropriately calibrated cost of debt, distribute a steady dividend stream to its equity investors and maintain the ability to raise new equity as needed to deliver on its investment plan.

7.34 To attain this position, it is essential first of all that the CMA sets price controls to provide for a higher expected return by addressing the following key areas of Ofwat's PR24 FD:

(a) On **Costs**, the CMA should: (i) adjust Ofwat's **base costs** models, post-modelling adjustments, and CACs to reflect the expenditure proposals in our PR24 DDR, (subject to an uplift of £54m to reflect the higher mains renewals rate assumed in Ofwat's FD); (ii) adjust Ofwat's **enhancement costs** allowances, by uplifting funding for specified enhancement lines as set out in Section 4 (Costs). This results in an additional PR24 funding allowance of approximately £129m for base and £227.4m for enhancement; (iii) amend Ofwat's frontier shift efficiency across base and enhancement costs to 0.5% p.a. from 1.0% p.a.

(b) On **Outcomes**, the CMA should: (i) adjust the **WSI PCL** as described in Section 5 (Outcomes), and lower the penalty collar to 0.5% of RoRE; (ii) for **C-MeX**, modify the calculation of company performance such that any inherent regional biases are removed; and (iii) remove the unjustified £3.9m penalty in AMP7 for **NHH voids**.

(c) On Risk mitigations, the CMA should: (i) Change the **ASM thresholds** to reflect a ±2.00% "lower" threshold at 50% sharing and ±3.00% "upper" threshold at 90% sharing ;[136] and (ii) remove the **OAM deadband** of ±0.5% to address expected underperformance.

(d) On **Cost of Capital**, the CMA should: (i) revisit the calculation of the **Cost of Equity**, taking into account the evidence set out in the Cost of Capital Report, and select a point estimate which is at least 6.32%; (ii) if remaining skew in the outcomes package persists, price in the risk of the residual skew into the **Cost of Equity**; (iii) revisit the calculation of the **Cost of Debt**, taking into account the evidence set out in the Cost of Capital Report, and implement an uplift of 56bps, from Ofwat's PR24 FD allowance of 3.15% to 3.71%; and (iii)

[136] We show in Annex H (Risk and Financeability) that a tightening of the ASM thresholds is needed to ensure that the notional company can cope with the level of downside risk embedded in the regulatory framework (above all, underperformance on ODIs and totex allowances) by retaining a minimum credit rating of Baa2/BBB (stable outlook) in compliance with the financial resilience licence provisions.

on the **Cost of Debt**, allow SEW a Company Specific Adjustment which reflects SEW's status as a small company that issues debt relatively infrequently.

7.35 We also request that the CMA replaces Ofwat's approach to testing financeability with a robust financeability assessment that appropriately analyses the debt and equity financeability of the price control package.

7.36 This will deliver a price control package that will allow the notional company – and SEW – to raise the capital required to support the significant capital delivery programme being implemented across AMP8 for the benefit of customers.

Postscript: SEW's actual financial position

7.37 All of the preceding analysis deliberately focuses on the position of a company with a notional capital structure. The real-life SEW has higher gearing than Ofwat's notional company and, as such, faces even greater challenges than we have identified above.

7.38 We took the view, and continue to believe, that we selected the most efficient capital structure that was available to us given the risk profile of the industry as it stood at the time and levels of financial headroom available to manage risk. We also accept that we need to revert to a more modest level of gearing now that the risk profile of the sector has changed and it has become clear that lenders/rating agencies are looking for a more substantial equity buffer in the face of significant increases in regulatory and operational risks for the industry.

7.39 Our ability to change our financing mix depends crucially, however, on the willingness of equity investors to put more equity into our business. There is, at this point, a direct link to the analysis in Section 6 (Risk and Return) and Annex H (Risk and Financeability) in that equity investors can only be expected to put new money into SEW if there is the prospect of a return that is competitive against the returns that can be obtained currently from other investments with a similar riskiness. However, Ofwat's FD does not provide competitive returns which can attract and retain equity capital.

7.40 This leaves SEW in the precarious position of relying on the existing shareholders needing to provide capital rather than being able to secure new capital from a deep pool of new as well as existing investors. We do not consider that limiting SEW's ability to raise capital from existing investors only, is in the interest of our customers, in the context of the step changes in investment required in our regions in AMP8 and beyond.

7.41 It follows that there will be a direct feed through our 2025-30 price controls to our real-world financeability and our real-world financial resilience. This does not change any aspect of the CMA's work on totex, PCLs/ODIs or the allowed return or any of the requests that we are making in this Statement of Case. However, it is important that the CMA understands that our ability to improve our actual financial position is inextricably linked to the outcome of PR24 and does not exist completely independently of the regulatory process.

south east water