Final Business Plan for 2010 to 2015

Part A - Overall Company Strategy

April 2009

Part of the 2009 Periodic Review (PR09)

South Staffs Water

Introduction

This document is a high level summary of the Company's Final Business Plan (FBP) submission to Ofwat. It describes the Company's investment plans for the next five years, how they fit into its long-term strategy and what this will mean for customers. The FBP develops the themes and proposals set out in the Company's Draft Business Plan (DBP), which it submitted to Ofwat in August 2008. The FBP is the second stage of the PR09 process, which ends with Ofwat setting price limits in November 2009 for the 2010-15 period.

Contents

1. High Level One Page Summary of the FBP

Over the next 5 years (2010/15), the average household bills for South Staffs Water customers will rise in total by 15.5%, excluding inflation, a total increase of £18 per household, which is £3.60 per year. Our current average household bill of £116 is therefore expected to be £134 in 2014/15. Capital investment per property will increase by 17% to £51 per year.

The main reasons for rising customer bills are:

- Increases in operating costs which will add around 11% to customer bills – the Company is going to experience additional annual running costs, most notably:
  - Power costs
  - Pensions costs
  - Abstraction costs payable to the Environment Agency
- Increases in the capital investment programme which will add around 2% to customer bills. The Company's investment programme will increase from £120m in the current 5 year period (2005/10) to £140m in the period 2010/15. The Company is confident that this is essential investment in the customers' interests.
- An increase in the cost of capital to reflect risks in the sector and the difficulty in raising finance.
- A modest increase in customer metering which adds 2% to customer bills.

Key assumptions in this plan include:

- Operating cost efficiencies of 0.3% per annum
- Capital cost efficiencies of 5% over the period
- A cost of capital of 6.3% in line with evidence prepared by NERA
- A modest rise in domestic meter penetration levels from 20% to 35% by 2015
- Steady levels of leakage at levels slightly lower than the current Ofwat target
- Continuation of existing levels of mains replacement activity

This FBP is based on the Company's best estimate of the future. As such, it does not contemplate a worsening of the present economic downturn beyond 2010. However, given recent volatility with respect to operations, including reduced demand, increased bad debt and increased numbers of meter optants, the Company would like to highlight the potential downside risks to this plan. It believes that stakeholders should consider this increased level of risk when evaluating the Company's FBP, including the assumed cost of capital and requested notified items.

The price limits in this FBP are in total 16.8% over five years and the yearly movement is as follows:

	2010/11	2011/12	2012/13	2013/14	2014/15
Price limit %	8.1	4.4	4.2	0.1	0.0
Average h'hold bill £	125	130	135	135	134

2. Developments since the DBP in August 2008

The Company has continued to build on the Draft Business Plan submitted to Ofwat in August. The following list summarises the main changes that have progressed. The changes largely represent responses to either the stakeholder feedback on the Company's DBP or changes resulting from the swift and significant economic downturn that has developed in recent months. Many of the issues are expanded upon later in this Part A document.

- Demand and income have fallen significantly because of the economic downturn and are forecast to continue to fall in 2009/10. This is a feature of the global recession and the possibility of further major income reductions is now the largest risk facing the Company. The Company considers that Ofwat should consider allowing for large users in the Revenue Correction Mechanism to help manage risk in the sector. The Company has engaged with Deloitte's Consulting to produce a robust income forecasting model.
- Bad debt is subject to a rising trend as a result of the economic downturn.
- There has been further scrutiny of the Company's future investment needs. The capital investment programme is nearly £20m (13%) lower than at the Draft Business Plan stage. Reasons include:
  - lower demand, again due to a forecast that customers will use less water as the recession worsens. This means that fewer sources will need to be available;
  - removal of schemes lacking robust justification through use of Cost Benefit Analysis (CBA);
  - keener contract prices for key areas, such as mains rehabilitation.
- The Company has engaged with Mott MacDonald, engineering consultants, to improve the presentation of its capital maintenance needs. This is partly in response to Ofwat's assessment of our capital investment proposals in the DBP.
- CBA work has significantly developed since the DBP, although the Company proposals are dominated by maintenance spend and it does not propose enhanced service levels. For discretionary policy decisions, such as the implementation of change of occupier metering, an improved CBA is now included in this FBP. The Company has also applied improved CBA to the vast proportion of its capital maintenance programme to help demonstrate the benefits and needs for this investment.
- A pensions actuarial valuation is now available and this identifies a need for pension costs to rise.

"The changes largely represent stakeholder feedback and the economic downturn."

- The cost of capital has been revised upwards to 6.3%, in line with the latest NERA report, and inclusive of NERA's small company premium estimate. Relative to AMP4, this increase reflects the re-pricing of risk and higher levels of volatility with respect to trading and in the financial markets. The Company also notes that this cost of capital figure is combined with a limited number of requested notified items and base opex additions.
- The Board has taken the decision to declare an expectation of opex and capex efficiencies. The DBP position was zero. The FBP adopts 0.3% per annum for opex and 5% for capex by 2015, to reflect the current economic climate.
- A power contract has been signed for the first 18 months of AMP5 - at prices better than the DBP expectation. Hence this reduces year 1 price limits. However, efficient power contracts generally have a maximum length of 24-30 months and the Company will continue to be exposed to price volatility. The consensus view of analysts is that the energy wholesale markets will be volatile in the short term, with a longer term trend of increasing prices. Although an allowance for further increases is incorporated in this FBP, power costs will remain one of the Company's biggest future risks, particularly given its high pumping head in comparison to other companies in the industry. There is therefore a need for power costs to be recognised as a notified item.
- The Environment Agency has provided notice of expected abstraction charge increases of 10% per annum in the Midlands region.
- The sustainable economic level of leakage (SELL) has been revised. The DBP projected a reduction in leakage. The FBP now proposes flat leakage at 74 Ml/d, albeit below the AMP4 target. With steady rather than falling leakage, the costs of leakage are lower in this FBP.
- The Carbon Appraisal produced for the DBP has been modified in line with Ofwat's feedback. Carbon remains an important issue for the Company, but the new appraisal now incorporates the shadow price of carbon rather than a least cost appraisal which was based on projections of the impact of the Carbon Reduction Commitment (CRC) scheme.
- A new lead pipe replacement scheme is included with DWI support.
- An additional notified item for the potential abolition of capital allowances has been included.
- Metering numbers have changed due to the recession. Due to lower house moves and new houses, the number of new connections and change of occupier meters is lower. However, consistent with the Company's experience since the economic downturn commenced, projected meter optants are higher as compared to historical levels. For example, while the Company's final determination at PR04 allowed for 3,242 meter optants in 2008/09, the actual figure was more than double this at circa 7,000.

"A power contract has been signed for the first 18 months of AMP5."

- Levels of service for DG3 (supply interruptions) and DG8 (bills based on an actual meter read) are revised in line with Ofwat's feedback on the DBP.
- The asset revaluation (MEA revaluation) now commences earlier than 2010/11 in line with Ofwat's guidance and this reduces year 1 price limits.
- Water efficiency targets are now incorporated, which leads to further measured income losses over the 5 years.
- The Company presents improved justification and targeting for investment in systems and IT. A project to review our current and future IT capabilities has been undertaken with PA Consulting and this has prepared a robust roadmap to ensure that the Company can continue to have efficient operations and continue to meet customers' rising service expectations now and for the future.
- The Cost Base has been updated and in conjunction with dialogue with Ofwat there is a revised presentation of some of our costs, particularly on the infrastructure side. Ofwat's December 2008 CIS baseline assessment included an 18% efficiency target from Ofwat for infrastructure expenditure which the Company considers to be unrealistic and unrepresentative of our actual relative efficiency for capital expenditure.

In comparing price limits between the draft and final business plan, the impact of these changes overall is that the year one (2010/11) increase in customer bills has fallen but the overall five year change is now slightly higher, due mainly to additional base opex increases.

	2010/11	2011/12	2012/13	2013/14	2014/15	Total
DBP	14.0	1.2	1.0	-0.7	-1.7	13.8
FBP	8.1	4.4	4.2	0.1	0.0	16.8

3. South Staffs Water's Overall Strategy

THE OVERALL FOCUS AND LONGER TERM (25 YEAR) STRATEGY

The Company has established a strategic focus on three particular issues, which collectively it refers to as the 3Cs. This is expanded upon within the Company's Strategic Direction Statement (SDS) document and reflects the emphasis that is placed within our decision making process on:

- **Customers** – delivering service excellence and providing a high quality customer experience
- **Carbon** – mitigating against the impact of climate change and adapting to the challenges this presents, particularly given our high pumping requirements
- **Costs** – minimising the cost of running our business operations

To review the Company's long term Strategic Direction Statement (SDS), **please click here.**

"The Company focus is on the 3Cs - Customers, Carbon and Costs."

BACKGROUND TO THE COMPANY

For readers not familiar with South Staffs Water, **please click here for Company background** or visit our website at **www.south-staffs-water.co.uk**

CURRENT POSITION AT START OF REVIEW

The Company position at the start of this review is strong, borne out by our ability to provide customers with:

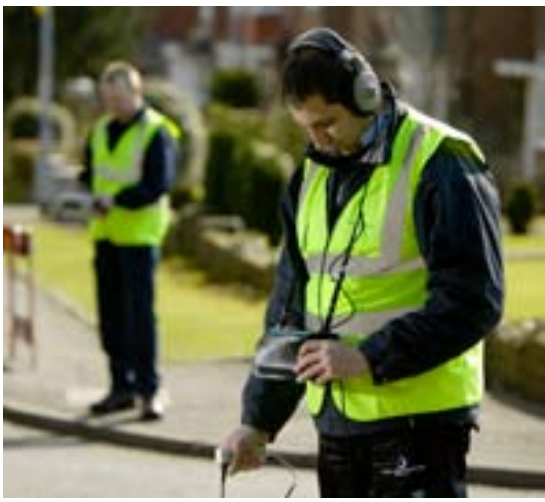
- Average household bill levels that are 25% below the national average for water;
- Service standards that have been consistently high, with our overall levels of customer service (as measured by Ofwat's OPA score) being in the top five of all companies for every year since 1999;
- No water restrictions such as hosepipe bans;
- Efficient operations that have been assessed by Ofwat as 'Band A' since 2002/03, representing companies with leading performance in terms of cost control. For energy costs, the Company is ranked first in Ofwat's efficiency models.

The Company's business plan is focussed on continuing this service excellence combined with low bills for customers, together with a response to rising energy prices and the challenge of carbon reduction.

REGULATORY OUTPUTS FROM THE 2004 PERIODIC REVIEW

The Company is able to report excellent performance against the outputs set at the 2004 Periodic Review (PR04). Service standards, both customer service and water quality, have continued to be at high levels. The Company has met its leakage target throughout the period. Through additional and better targeting of mains replacement activity, the level of burst mains experienced has reduced, enabling the underground asset serviceability assessment to change from "marginal" to "stable". In terms of schemes and activity levels, more customers have chosen to have a meter installed than envisaged. Also, the Company's supply network reliance has been enhanced by the completion of a duplicate trunk main from its largest treatment works that transfers water to serve the Black Country conurbation. Surface assets, such as treatment works and pumping stations, have also performed well and the serviceability assessment in this area has remained "stable".

Overall, after nearly four years of the 2005-10 review period, all regulatory outputs from the last Determination (PR04) are set to be achieved.



Leakage detection equipment

HOW THIS PLAN HAS EVOLVED

The Company has always sought to produce sound business plans that are successfully delivered, allow it to keep customer bills low and provide service excellence. The business plans are carefully considered and have wide ownership across the Company. Its approach at this review has been to build on this, with particular features to emphasise as follows:

- Detailed customer research, to develop thinking on long term strategy and to assist with building up proposals that are consistent with customers' willingness to pay.
- Production of a long term strategy, the Strategic Direction Statement, as a foundation for the overall strategy for this business plan and for ensuring proposals look beyond five years.
- The assessment of the condition and performance of above ground assets has been more substantial at this review, drilling down to asset (equipment) level rather than overall process or site level. The Company is fortunate to have a small number of supply assets. Through experience and knowledge this provides the opportunity for a sanity check on the outcome of this detailed assessment.
- The assessment of underground mains has built on the foundation of work established for PR04, enhancing the knowledge the Company has on the condition and serviceability of its network infrastructure.
- A steering group to oversee the development of this business plan has operated for the last two years with involvement of all four of the Executive Board Directors of the business.

"All regulatory outputs from the last Determination (PR04) are set to be achieved."

STRATEGY ON CLIMATE CHANGE AND USAGE OF CARBON

The Company remains committed to adopting carbon efficient strategies consistent with its 3Cs core values (Customer, Carbon and Costs) and its Strategic Direction Statement. However, the Company recognises that carbon targets should not be the only drivers for investment. The Company's FBP and the supply demand balance strategy within it is underpinned by cost benefit analysis and by customer views. Carbon is a key component of the environmental and social aspects of cost benefit analysis and is therefore integrated throughout the plan and is not considered in isolation.

The Company's carbon reduction strategy includes three main areas:

- First, the Company will further extend its very successful energy management programme and undertake works to further improve overall pumping and energy efficiency.
- Secondly, the Company will undertake a business review of options to change it's principal infrastructure, possibly through the construction of trunk mains and a low level service reservoir. Investigation works will be undertaken in AMP5 and if the business case for such investment and the engineering logistics are both positive, implementation would begin as early as possible post 2015.
- Thirdly, the Company's proposed change of occupier metering programme and the continuation of the optional metering programme will reduce the volumes of water the Company treats and pumps on a daily basis.

Each of the above schemes has been assessed using cost benefit analysis and have been proven to be cost beneficial when all quantifiable costs and benefits have been included.

STRATEGY TO PREPARE FOR COMPETITION

The uncertainty over the future implementation arrangements for competition make it difficult to include specific investment proposals. The Cave Review and Ofwat's commencement of accounting separation do provide some indications that it is likely that, as a minimum, amendments to IT systems will need to be made in the 2010-15 period. This will facilitate the operation of a successful competition regime, in whatever format that materialises.

Aerial view of Blithfield reservoir

"The Company remains committed to adopting carbon efficient strategies."

CUSTOMER METERING STRATEGY

Domestic metering penetration levels, based on a modest increase in metering levels outlined in this plan, are projected as follows:

Current (2007-08)	20%
2014/15	35%
2019/20	48%
2024/25	60%

Current domestic metering levels at 20% are very low compared to other companies. The industry average level of household meter penetration is currently 35%. This reflects the healthy resource position of the Company and its low level of charges. However, consistent with the Company's experience since the economic downturn commenced, projected meter optants are higher as compared to historical levels. For example, while the Company's final determination at PR04 allowed for 3,242 meter optants in 2008-09, the actual figure was more than double this at circa 7,000. This highlights the uncertainty over future metering numbers, which is why the Company requests a notified item to be retained. Extra metering creates extra capital and operating costs, together with an adverse effect on turnover and cash flow.

The Company considers that it is now sensible to commence change of occupier meter installations. This will allow a modest growth in metering that is sustainable in the long term. Hence this policy is in line with the Company's Strategic Direction Statement. This recognises that more metering will assist with:

- demand management
- water efficiency promotion
- a need to reduce the carbon footprint of the Company

The Company has the highest pumping requirements in the industry. There are steps we can take to improve this position, but it also needs customers to act to reduce its carbon footprint. Metering is needed for this customer response to be realistic. Linked to this is the need to secure penetration levels sufficient to introduce new tariffs that send effective price signals to customers to reflect the burden of excessive peak demand use.

Other benefits of metering, possibly of less significance, include:

- fairness in charging
- removal of cross-subsidies
- movement away from out-of-date RV charging (property values in 1990)
- greater accuracy in leakage level estimation

The Company has successfully trialled change of occupier metering in 2008/09. It will continue the policy into AMP5. Industry research has indicated the demand savings from change of occupier meters are higher than that of meter optants. CBA work has also shown that there are positive benefits from pursuing a policy to meter customers on change of occupier. Other metering growth continues with new housing development and free meter options. If the feasibility of long term plans

Customer checking meter reader's identity

"The Company considers that it is now sensible to commence change of occupier meter installations."

for network reconfiguration is negative, an early start to more metering growth in 2010 would reduce the need for metering growth over a shorter timescale in future review periods.

The metering numbers proposed in the FBP are as follows for the 5 years:

	2005-10 Actual/Forecast	**2010-15** Forecast
Meter options (customer choice)	29,750	30,500
Change of occupier metering (compulsory)	300 (trial)	15,500
New housing connections	16,750	20,500
Total	**44,800**	**66,500**

LEAKAGE AND RESOURCE POSITION

Overall the resource position of the Company remains healthy with 100% supply security. This position does influence the need to reduce leakage levels which can be very costly. There are no plans for resource development. This means that, provided the Company can continue to maintain our major treatment works and our boreholes, the Company will be well placed to maintain supplies including at times of extreme weather periods.

The current regulatory leakage target is 75 Ml/d. The Company's latest assessment of the sustainable economic level of leakage (SELL) is steady at 74.4 Ml/d.

WATER QUALITY STRATEGY

The quality of water provided to customers is very high. For 2007 the overall water quality compliance was 99.97%. The Company does not require any new water quality processes to be installed. Instead the focus is within capital maintenance to ensure the treatment processes and instrumentation are maintained to a standard that keeps them serviceable and accurate.

The quality capital investment contained within this business plan largely relates to two areas:

I. The first is security expenditure under the Security and Emergency Measures Direction (SEMD) legislation to make sure its assets are secure from terrorism and vandalism.

II. The second is a lead pipe replacement scheme supported by the DWI in two geographic areas. Risk analysis suggests action is required in addition to phosphate dosing to meet the forthcoming more stringent lead standard.

There is one water quality issue, the pesticide– 'metaldahyde', that has been recently detected. The Company has not included investment for treatment of this pesticide, but this will need to be investigated and managed through joint catchment management practices.

CCTV investigation used as part of the borehole maintenance process

"The resource position of the Company remains healthy."

PROTECTING THE ENVIRONMENT

The Company will continue to investigate the impact of its abstractions on the environment, including designated Habitats Directive sites and sites of special scientific interest (SSSI). Where such investigations develop over the next few years, by definition, there is uncertainty over the outcome arising. The Company has eight sites under review, two of which relate to the Habitats Directive. Three investigations relate to the Water Framework Directive. The willingness to pay research results from our customers seems to support this activity.

At PR04 there were investigations to be undertaken at Checkhill Bogs SSSI. Following these investigations, at this review (PR09) there is now an implementation scheme to reduce abstraction by 2 Ml/d.

Whilst there are no major issues over the AMP5 Environmental Programme, the Company highlights that this plan budgets for the 10% increase per year in abstraction charges in the Midlands region.

Abstraction works at the River Severn at our largest source, Hampton Loade.

CUSTOMER SERVICE STRATEGY

The Company intends to maintain the excellent service standards that our customers receive over the next five years. Opportunities will be taken to respond to advances in technology and new best practice in terms of service delivery. Providing high standards of service and putting the customer first forms part of our overriding business strategy that is based on the 3 C's (customers, carbon, costs).

"The Company intends to maintain the excellent service standards that our customers receive."

GOVERNANCE AND COMPANY OWNERSHIP OF BUSINESS PLAN

Linked to the above is the importance of governance and Company ownership. The business plan is largely a projection of future operating conditions and is thus based on forecasts of the future. The governance arrangements have hence been to focus on reliable data as a starting point for any projections, to ensure that overall systems for business plans are robust, and to confirm that the business plan submitted is consistent with the overall business strategy. A more detailed statement on the Company's governance position, Director involvement, processes and focus is available, **please click here.**

FUTURE SERVICE STANDARDS

The plan is focussed on continuing to provide customers with excellent service standards. Customer research shows that 94.8% of domestic customers and 91.8% of commercial customers are satisfied with the service the Company provides. Consequently, this plan does not include any major enhancement to customer service provision. In making investments to replace assets and in reviewing business processes, the Company will seek to develop service in line with changing customer expectations and in line with advances in technology and automation.

BOARD APPROVAL

This document has been reviewed and approved by the Board of South Staffordshire Plc and South Staffordshire Water Plc.

4. Summary of Customer Benefits Arising from this Business Plan

The Company has listened to customer views and sought to follow a strategy that incorporates these views. The principal benefits arising from this plan include:

1. Improved customer access for operational contact, billing queries and payment options in order to maintain existing high levels of service, as well as meeting customers' increasing expectations.

2. Continued investment to make sure that service continues as normal during extreme weather events, such as droughts, floods and severe winters. Asset resilience to such weather events is very important.

3. Replacement of those water mains that are most likely to burst or leak, at stable activity levels into the long term. Our customer research confirmed their desire for continued action by the Company in this area.

4. Further investment in systems, IT and automation to:-
   - Sustain high operational efficiency, thus keeping customer bills low.
   - Allow customers to have improved response times, more ways of contacting the Company and the opportunities for such facilities as internet/email billing.
   - Gain better customer information regarding job activity, e.g. knowledge of when burst mains have occurred nearby to their address.
   - Improve the capabilities to schedule jobs for customers directly, making appointments for work such as meter installations or repairs to leaks on premises.
   - Improve our response times to leaks through better scheduling of jobs.
   - Improve customer data management and the Company's efficiency by managing paper documents electronically.

5. Proposals to reduce the Company's carbon footprint. This will be achieved through assisting customers in their efforts to be more water efficient and reducing the Company's reliance on systems that require high carbon usage. Customer research supported a strategy that focuses on both carbon and water efficiency.

6. Additional investigations, in partnership with the Environment Agency, to determine if any water abstractions are damaging to environmentally sensitive sites of special scientific interest. Customers supported environmental protection in the willingness to pay research the Company undertook.

Mains replacement

7. Sustained efforts to control debt levels. During challenging economic conditions it is in overall customer interests for debt to be effectively managed. Otherwise debt and collection costs will rise and this would be reflected in all customers' bills. The Company will explore if new tariffs can be designed to control debt levels.

8. Continuation of water quality excellence, ensuring that the treatment processes installed remain fit for purpose to meet the stringent standards expected from both customers and quality regulators.

9. Ensuring the Company has enough resources in place to provide a prompt and complete response to any customer contact.

10. Investing in intelligent meters which will allow customers to better understand their consumption profiles. If they wish, they could then reduce their usage to be more efficient and lower their bills.

Clarification treatment process at Hampton Loade Water Treatment Works

These above points summarise the customer benefits from the business plan. However, three issues are worthy of note:

- It is unfortunate that many of the reasons for price changes are beyond our control and do not lead to improvements for customers. For example, increases in costs like power, business rates and abstraction charges do not lead to improvements in service to customers from their water company.
- Secondly, the Company's future capital investment programme will bring many benefits to customers. Hence this section should be read in conjunction with section 6 of this Part A document.
- Thirdly, due to the unprecedented volatility, the economic downturn has resulted in many adverse effects including reductions to demand, increased bad debt, inflation volatility, and reduced profits and cash flow, to name only a few. The Company's FBP balances risk and a limited number of notified items and base opex additions against the need to maintain the Company's creditworthiness and adequate profitability. Thus the cost of capital of 6.3% is an integral component to this FBP request.

CUSTOMER ASSISTANCE

The Company recognises that during the present recession a large number of customers will struggle to pay their bills. In response to this, the Company will:

- Actively promote meter options which for some customers can enable them to save significantly;
- Continue to operate the Charitable Trust, increasing the financial support available to those most in need;
- Work in partnership with local Citizen Advice Bureaus (CABs) and other support agencies to help customers and target assistance accordingly;

- Allow flexible payment arrangements, including weekly and monthly instalments;
- Tailor debt collection activity to take account of cases of genuine financial hardship;
- Promote the newly introduced single person occupancy discount for the assessed charge, which applies when meters cannot be fitted;
- Review the potential for tariffs to be designed to support socially disadvantaged customers in the AMP5 period, subject to Ofwat's approval.

The Company's household bill is 25% lower than the national average and this will further assist customers during this difficult period.

The profile of proposed bill changes in this FBP is also smoother than that in the DBP, with a lower year 1 change. This will assist customers.

5. Future Income Projections

The DBP noted the Company's emerging concerns that the credit crunch and general economic downturn could be a major reason for changes to customer bills from 2010. The Company also noted that at the last review in 2004 over one-third of the increases in customer bills resulted from revenue losses.

Control room at Seedy Mill Water Treatment Works

Since the DBP there have been two notable developments:

- Firstly, measured income from commercial customers has declined significantly during 2008/9 and is expected to continue to reduce in 2009/10 as the impact of the recession, particularly on large users, has been greater than anticipated. Revenue from metered commercial customers in 2008/09 is approximately 9% lower than 2007/08 levels.
- Secondly, the Company has taken steps to improve the projection of future income by engaging with Deloitte's Consulting to review past trends and identify the explanatory variables that influence the demand/income of our commercial customers.

Income projections are broadly stable since modest reductions from commercial customers are offset by income from new properties assumed to be built in our area. Some recovery from the current recession is anticipated in line with independent forecasts . There is, however, no guarantee that this economic recovery will occur, or as quickly as assumed. Risks include reductions to new household additions, further demand reductions from commercial customers and the closure of businesses. The Company submits the income projections underlying this FBP on the assumption that large industrial users are included in the revenue correction mechanism. If they are not, the risks which the Company would be exposed to are disproportionally high. Thus the Company's FBP balances a projected modest demand reduction with some protections should the economic downturn continue beyond 2009-10. Even with the revenue correction mechanism in place, the Company will continue to be exposed to these factors due to timing differences arising from the volatility of today's trading environment.

The extent of future water consumption and hence income from large users and other commercial customers will depend on two issues:

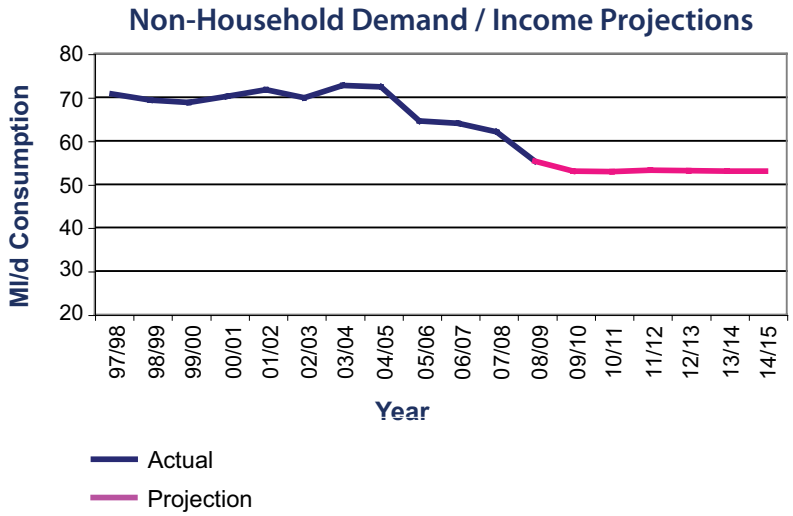
- If the large users introduce new production processes to permanently use less water, e.g. water efficiency plant, or if they do not survive the recession and cease trading. Both of these factors will lead to a permanent reduction in revenue.
- How long the recession lasts. Post recession consumption and income should increase at some point although it is not clear that it will ever return to the levels pre 2008.

The Company considers that the income and non-household demand forecast is now based on reliable data sources and sophisticated statistical tests to ensure that the most appropriate econometric model is available, using relevant explanatory variables. It has been subject to sensitivity testing and independent scrutiny. The resultant model is one

that the Company will use for internal budgeting purposes, it is not just produced as PR09 evidence.

The Deloitte's income model is a major advancement in the robustness of this business plan. Rather than just taking recent trends and assuming the future will be similar, the Company now has more evidence based sub-models that assess the explanatory variables applicable in twelve different industrial sectors of the Company's non-household customer base. Deloitte's have analysed the largest eighty customers taking their monthly consumption data over the past 12 years. This analysis produced overall future demand/income projections by sector that were then transposed onto the Company's full non-household customer base (35,000 customers).

Sensitivity analysis was undertaken and this business plan forecast is based on the central scenario and is shown in the graph below:



The decline in non-household demand over the past three years to 2007/08 has been 14%, with a further reduction of 11% in 2008/09 experienced. This is due to the historical, economic and business conditions in the areas in which the Company operates. Against this backdrop, a further 4% decline in non-household demand in 2009/10, followed by broadly stable demand is projected. This forecast may prove to be too optimistic.

In terms of breakdowns of analysis from the 12 industry groups that in aggregate form the basis of the data in this graph, the following forecasts were reached:

- Breweries, food and drink, iron and steel, mining and the service sectors show a projected fall in demand in 2008/09, followed by recovery in 2009/10 and relative constant levels of demand thereafter;
- Chemicals, engineering, laundry and metals show an accelerated fall in demand in 2008/09, followed by a reversion to a slower long-term rate of trend reduction in water demand; and
- Demand in the agriculture and sports/recreation sectors holds up in 2008/09, with agriculture projected then to fall in 2009/10 before resuming the long-term upward trend in demand, and sports/recreation demand remaining broadly flat beyond 2009/10.

Further commentary is available in section B5 of this Business Plan.

Breweries, a key sector amongst our commercial customers.

"The decline in non-household demand over the past three years to 2007/08 has been 14%."

6. Capital Investment Requirements

2007/08 prices, net	2005-10 (AMP4 FD)	DBP for 2010-15	Ofwat CIS Baseline	FBP for 2010-15
SDB	£19.3m	£25.5m	£4.2m	£16.1m
Q	£3.2m	£2.2m	£2.1m	£2.3m
IRE	£48.5m	£52.5m	£34.3m	£47.7m
MNI	£49.0m	£79.3m	£49.0m	£73.9m
Total	£120.0m	£159.5m	£89.6m	£140.0m

This capital programme of £140m equates to capital investment per property of £51 per year which is amongst the lowest in the sector.

The FBP capital investment requirements for AMP5 are now nearly £20m (13%) lower than the levels at the DBP stage. However, the future programme remains higher than current AMP4 (2005/10) levels. This section seeks to explain this position and provide further clarity on why future investment is required and the benefits it will bring. Overall the uplift to the capital programme adds around 2% to customer bills over the next 5 years.

This section on the capital programme is structured as follows:

- Reductions since DBP
- Comparison to Historic Levels and Main Reasons for Changes
- Capital Investment Summary By Category (SDB, Quality etc.)
- Longer Term Investment Needs Beyond 2015

REDUCTIONS SINCE DRAFT BUSINESS PLAN

The net capital investment programme at the DBP stage was £160m. It is now £145m pre-efficiency and £140m post-efficiency. The main reasons for this £20m (13%) reduction are:

- A reflection of the lower customer consumption levels prevailing and hence a review of whether so many supply sources need to be fully refurbished in the next five years. The Company is taking the risk that some investment may be delayed until after 2015 given the lower customer demand. Insofar as the demand projection in connection with the FBP is deemed to be higher, the Company would expect a higher level of capital investment to be assumed in the Determination.
- Further reviews at a senior level of the justification and need for investment schemes, removing those that do not pass the cost benefit analysis test and furthermore do not appear to be essential investment or fully justified;
- Evidence that some contract prices for investment delivery may not be as high cost as forecast at the DBP stage – this particularly applies to the cost of infrastructure renewals where the unit price for mains replacement activity is now lower;

Mains replacement - pipe bursting process, minimal disruption to customers.

- A variety of consequences of the economic downturn, for example less new housing and also fewer people moving house, which reduces the ability to install meters on change of occupier;
- A review of the economic appraisal of carbon schemes in the draft plan. In focusing on the shadow price of carbon rather than a projection of potential Carbon Reduction Commitment (CRC) charges, investment such as leakage reduction expenditure is no longer justified;
- An expectation of 5% capital efficiency. At the DBP stage the Company assumed 0%.

Mayfield service reservoir roof

COMPARISON TO HISTORIC LEVELS AND MAIN REASONS FOR CHANGES

As stated earlier, whilst the FBP capex is lower than the DBP position, overall it remains at a higher level than historic levels. The net capital programme in the current period (2005-10) is £120m, making the FBP capex of £140m a 17% increase.

The main reasons for the uplift in future capital expenditure are as follows:

- Refurbishment of deteriorating boreholes
- Maintenance or replacement of many short life assets, including previous Q and SDB spend
- Replacement of M&E treatment assets (e.g. assets to treat the water plant and instrumentation) to maintain serviceability
- To meet increased metering requirements in line with Company Policy
- Maintenance of DMA's and pressure management devices to continue to achieve leakage targets
- Refurbishment of deteriorating service reservoir structures, particularly the roofs which are prone to leak
- Maintenance of the reliability and efficiency of pumping plant
- Further investment in systems and IT capabilities to yield efficiencies and collect appropriate data to make support investment decisions
- Price increases in excess of inflation, particularly for infrastructure assets

CAPITAL INVESTMENT SUMMARY BY CATEGORY (SDB, QUALITY ETC.)

In terms of the five key components of the investment programme:

Supply Demand Balance (SDB £16.1m net): The Company has no new resource needs - these would be required should we have a deficit in water availability. Equally there is no reason to reduce leakage levels. The Company has no climate change expenditure specific to the UKCIP scenario. Some modest growth in metering levels are proposed and this will be achieved through a policy of change of occupier metering. Other SDB expenditure relates to the normal expenditure arising from new developments where we lay new mains and infrastructure. Section 11 provides further details of our policies on metering, climate change and leakage.

Quality (Q £2.3m net): Water quality expenditure is much lower than in previous periods. New treatment processes were installed over the past two decades to meet more stringent standards and the emphasis now is on maintaining this plant and equipment. This is one of the reasons why more capital maintenance expenditure is required going forward. There are minor expenditure schemes in the future water quality programme to protect the environment.

The only two significant water quality expenditure drivers relate to security of infrastructure protection and to a new scheme to replace lead communication pipes. This lead scheme has the support of the quality regulator (the DWI) and it features around £1m of spend to replace lead communication pipes in zones where the risk assessment undertaken by the Company suggests the likelihood of breaching the more stringent EU lead standard from 2013 is high. Around half the spend is opex since it involves replacement of customer supply pipes. These will remain the assets of the customer and they will retain existing responsibility for their maintenance. This investment scheme will also determine if there is an alternative long term strategy involving lead pipe replacement that may reduce the need for phosphate dosing which is itself an expensive and carbon-intense process. The SEMD investment is all Government "advice note" driven.

Infrastructure maintenance (IRE £47.7m net): The Company proposes to continue with current activity levels to replace the worst water mains that are susceptible to bursting and leakage. Whilst activity levels are flat, the cost of this work has risen since our last business plan in 2004. The Company is projecting costs in line with current experience despite an historic rising trend, it is not forecasting further cost uplifts. This is a risk that the Company will need to manage. Customers are keen for the Company to control burst levels and keep supply interruptions to a minimum. Mains replacement activity is the principal activity undertaken to achieve this.

Above ground asset maintenance (MNI £73.9m net): For maintenance of non-infrastructure assets this FBP includes a business case to increase gross levels of expenditure from £54m to £79m over 5 years. Net figures reflect Severn Trent's contribution to investment at our largest source, Hampton Loade. The reasons for the MNI uplifts required are summarised in the table below. There is no single overriding reason for the uplift, but a common theme is the first time replacement cycle that is evident in the 2010-15 period.

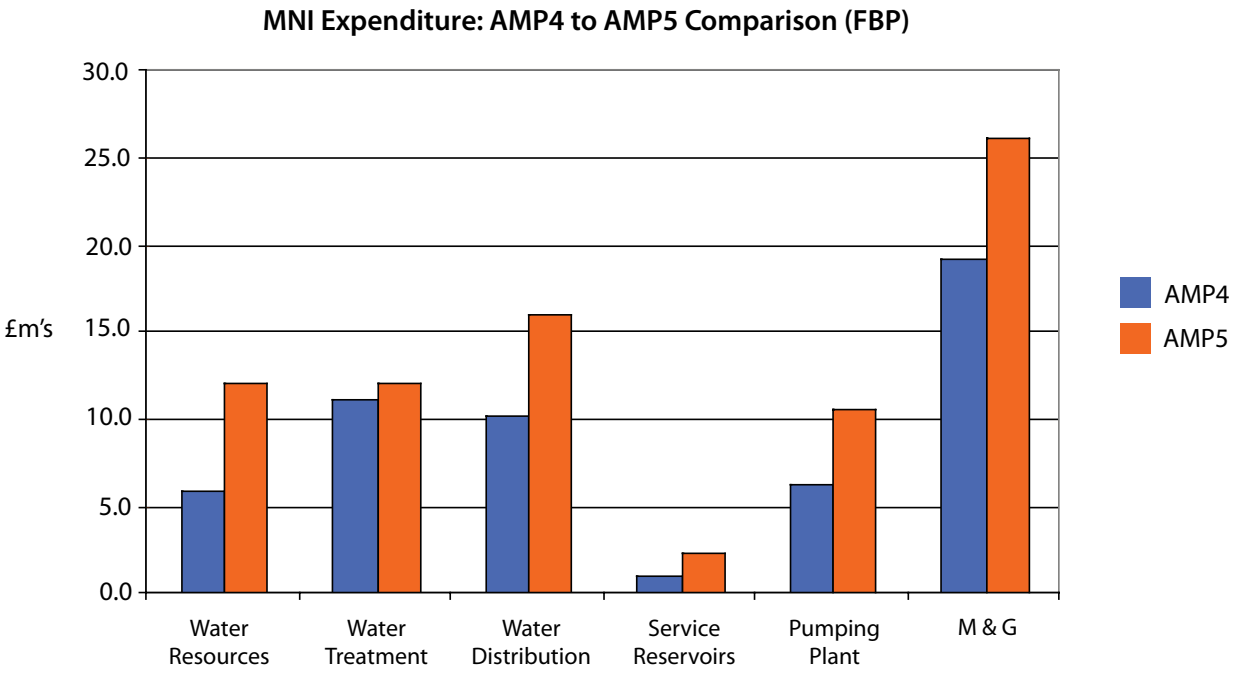
Water quality instruments at Hampton Loade Water Treatment Works

Categories	AMP5 £m	% Uplift	Reasons for uplifts and impact of investment not proceeding
Water Resources	**12.1**	**104%**	Recent performance data confirms a number of boreholes need replacement or refurbishment. These are 100 year life assets and historic maintenance spend is minimal. Without the start of a 15 year programme, risks of customers experiencing supply constraints during peak demand periods would be unacceptable. Also, without the boreholes being available more expensive sources would need to operate which compromises efficiency. This £5.7m investment in boreholes is important as 50% of water comes from such sources. This investment is often lumpy, given the long life of the assets involved, and can have more of an impact on a small company.
Water Treatment	**12.2**	**8%**	Over the past decade the Company has installed lots of complex, short life assets. This investment in new assets allowed lower levels of maintenance spend in the past. Going forward, without maintenance of this treatment plant and instrumentation, the risks to supplying customers with poor water quality and incurring supply capacity problems are too high to ignore.
Water Distribution	**16.0**	**55%**	As with water treatment assets, the Company has over the past 2 decades installed many new customer meters and lots of assets to control leakage levels. Examples included pressure management devices and district meters. These have assets lives ranging from 7 to 15 years and need replacing to maintain data accuracy so that customer billing and leakage control remains well managed.
Service Reservoirs	**2.3**	**101%**	The Company operates with only 1.2 days storage, the lowest in the sector. Around 20% of our service reservoirs have deteriorating civil structures, most commonly the roofs. With so few assets, it is imperative they remain operational to maintain continuous supplies to customers and to avoid bacteriological failure in the quality of water supplied.
Pumping Plant	**10.6**	**68%**	A number of factors are driving increased activity: • When power prices increase it becomes more cost effective to undertake more pump refurbishment work. The Company has the highest pumping head requirements in the sector, hence the significance of rising power prices is greater. • Similarly, energy usage needs to be controlled to manage our high carbon footprint. Activity levels are high for these reasons and because the borehole programme will generate a need for new pumping plant. Wherever possible, the spend levels are controlled by seeking to refurbish rather than replace existing pumping plant.

Management & General (e.g. customer service, vehicles, offices, IT)	**26.2**	**36%**	M & G investment covers a wide range of activities, including:
			• Maintenance of IT systems to ensure debt levels are managed, customer operational activity is efficient, to meet changing customer expectations for service and how our customers interact with us for contact and billing. This investment will allow customers to contact the Company and pay their bills in different ways and with improved response times.
			• An improved appointment system will be established to allow customers to schedule work directly e.g. meter installation, new connections, leak on premises repairs.
			• Our response times to leaks will improve through better scheduling of jobs.
			• Investment in IT systems will lead to better customer information regarding job activity, e.g. knowledge of when burst mains have occurred nearby their address.
			• There is very modest investment proposed on:
			  • maintenance of security assets;
			  • telemetry systems used to automate supplies to customers since only two of our largest sources are manned ;
			  • office maintenance;
			  • fleet vehicles and plant to maintain our customer operations.
			This is all essential to ensure our operations are efficiently delivered and our service to customers remains of the high standard they expect.

Total	**79.3**	**46%**	

This data is illustrated in the following graph:



Enhanced Service (£0): There is no requirement for any "enhanced service level" expenditure, which arises when particular service performance is not acceptable and hence needs substantial investment to improve. This does not apply to us as our existing service levels are high.

LONGER TERM INVESTMENT NEEDS BEYOND 2015

It is difficult to forecast long term future investment needs accurately, but current expectations are that investment in the period beyond 2015 is likely to encompass further increases in investment to reflect:

- A potential to radically change the layout of the network to reduce pumping requirements and use of carbon. Over the next 5 years the Company proposes to investigate potential network reconfiguration schemes with a view to investment post-2015;
- Potential for further additional metering uplifts given that the Company will only be at around 35% penetration by 2015, possibly around half of the industry average position. This will be subject to an economic assessment to be undertaken at PR14;
- Further capital maintenance to reflect the growth in the asset base;
- Allowance for capital maintenance that will be delayed from AMP5, as previously noted. Due to factors like the economic recession which has lowered customer demand this allows us to operate in the short term with fewer sources stations being fully operational. In the long term as customer demand grows, more sources will need maintenance to ensure they are operational.

7. Future Operating Costs

The following table summarises the year 1 increase in operating costs anticipated and the position at the end of the review period (2014/15), compared to current base levels in 2008/9. The year one impact on customer bills is around 5% and by year five this has risen to 11%.

	Year 1 (2010/11)	By Year 5 (2014/15)
Power	£2.3m	£5.6m
Pensions	£1.3m	£1.3m
Traffic Management Act (TMA)	£0.2m	£0.3m
Debt	£0.2m	£0.2m
EA charges	£0.2m	£1.4m
Total:	£4.2m	£8.8m
Bill Impact:	5%	11%

High lift pumps at Hampton Loade Water Treatment Works, refurbished with high efficiency motors but retaining the existing pump

Power costs: The Company has signed a two year contract to purchase electricity at £49 per MW/hr from October 2009. This wholesale price is lower than the £74 per MW/hr assumed at the DBP stage and reflects the impact of the current economic downturn. Whilst the Company is pleased with this contract price, it still represents an increase on the existing cost of £37 per MW/hr. For the remaining 3 ½ years of the AMP5 period the Company anticipates wholesale prices to rise in line with the Bergen Energy report (circa £80 per MW/hr).

The benefit of reduced consumption from commercial customers has been reflected in these power costs. The Company has the highest pumping requirements in the sector. This makes changes in power costs very sensitive to our operating cost position. It is possible that future changes could trigger a shipwreck clause. The Company's ability to use and procure power efficiently, making us the frontier company for this sub-model in Ofwat's efficiency assessments, helps minimise the customer bill impact of rising power prices.

Pensions: The Company has taken advice from pensions trustees and the cost increase reflects the recent full actuarial valuation undertaken. This is based on a 10 year deficit recovery period reflecting the remaining service of employees and guidelines from the Pensions Regulator. Employee contributions are currently 8% and are expected to increase in order to reduce this deficit. Also, the Company has historically contributed above the minimum levels advised by the trustees. The final salary pension scheme was closed to new members in 2000.

TMA: Part of the Traffic Management Act involves permits to work on the highway which are being introduced. These costs are included in the FBP. Others parts of the TMA are less certain but could be very expensive, for example complete highway re-surfacing rather than trench replacement. These costs are not in the FBP and are therefore the reason for the Company wishing to see a notified item for this risk.

Debt costs: A modest increase is inevitable in view of rising water bills and the economic downturn. The figures included are considered best-case – i.e. they only relate to the debt charge from the increase in bills and not to the likely costs of extra collections activity needed to maintain performance in a difficult collections environment. Because this FBP does not include bad debt as a notified item, there is substantial risk associated with a further deterioration in economic conditions, beyond the amount included.

EA charges: The Environment Agency has advised in writing that abstraction charges in the Midlands Region will rise by 10% per annum in real terms in the period to 2015.

Business rates: Any increase in business rates is not included in this FBP. The Company has been notified of a draft Rateable Value (RV) by The Valuation Office which is 75% higher than the current RV. However, this RV is not confirmed and the Company does not have any indication of the likely business rates poundage nor any transitional relief arrangements that may prevail. Once this information is confirmed the expectation is that Ofwat will include any business rate impact at the Determination stage.

OSEC disinfection dosing pumps at Hampton Loade Water Treatment Works

8. Scope for Efficiencies

The Company has reached decisions on the scope for efficiencies taking account of:

- the prevailing economic climate
- the desire to have incentives remaining
- the Band A status achieved
- the limited scope to absorb new cost pressures that exist when the Company's existing costs and operations are efficient

Our headquarters located in Walsall

Operating cost efficiencies: The Company has now included an efficiency improvement of 0.3% per annum cumulative, to reflect current expectations, particularly given the economic downturn. This reflects the fact that it is one of the most efficient companies in the industry having achieved Band A status and been able to deliver efficiencies in the past. The figure of 0.3% is consistent with the PR04 Determination for leading companies. At the DBP stage a zero efficiency allowance was assumed by the Company. The proposed efficiency savings is the net result of unfunded cost increases and initiatives by the Company to drive down cost.

Capital expenditure efficiencies: At the DBP stage a zero efficiency allowance was assumed by the Company. The Company has now included an efficiency improvement of 1% per annum cumulative, to reflect current expectations, particularly given the economic downturn and further innovation in capex delivery. Therefore by year 5 (2014/15) capex efficiencies of 5% are assumed. This 1% per annum improvement also applies to infrastructure renewals expenditure and this will be a major challenge to achieve given the lack of opportunities for innovation in this activity and in view of the rising trend in cost levels experienced to date. The Company notes that Ofwat's infrastructure efficiency assessment in its December 2008 CIS Baseline announcement was 18%. The Company strongly believes that this is not realistic or representative of our actual position. This is especially true given that the Company has been Band A for capital efficiency and its spend levels are materially lower than industry levels.

9. Future Risks & Uncertainties

This business plan does not:

- Assume an extended recession (post-2009/10) or further deterioration in key economic indicators, including GDP, employment, inflation volatility etc.
- Include contingencies for unforeseen events or legislative changes
- Take a worst case view of future cost rises
- Seek to include every possible cost increase

In addition, this section of the FBP should be read together with the 6.3% cost of capital estimate. In light of the Company's balanced approach to key assumptions, including income projections, base opex additions and notified items, it believes the requested cost of capital is essential to compensate for the unprecedented volatility and the risk that the Company is experiencing.

Section 7 has shown that base opex increases are only included in five areas where the cost changes that are anticipated are significant and where there is a high likelihood of cost changes being experienced.

The Company considers that the two largest risks that it faces in the future relate to income and power costs. Allowance has been made in this plan for a further deterioration in income in 2009/10, with some recovery thereafter. Power costs reflect the existing contract until October 2011, with an assumed increase thereafter. There is a significant risk that income and/or power costs are worse than has been assumed.

This business plan includes a short list of two-way notified items, for:

- Power costs
- Metering numbers – continuation of the logging up/down mechanism
- Traffic Management Act (TMA) costs, notably highway re-surfacing
- Potential abolition of capital allowances (or major changes to this tax regime)
- Carbon Reduction Commitment (CRC) scheme charges

Additionally, in view of the material risk of further income reductions, the Company believes that Ofwat should consider including large users within the new Revenue Correction Mechanism.

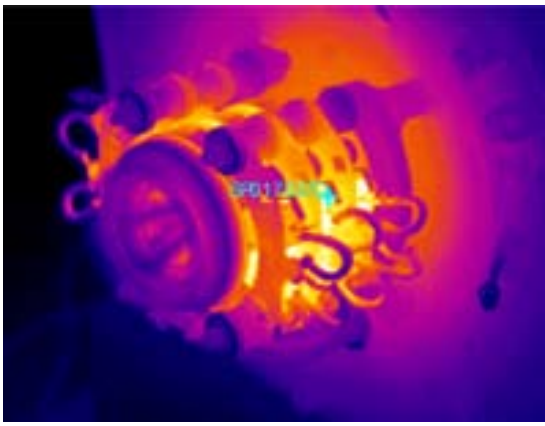
Later on in the financing section of this report the Company discusses its position on the cost of capital. It has taken a point at the higher end of the NERA range which should be viewed in conjunction with its position on a short list of base opex additions and a short list of notified items. A low capital programme, being the second lowest proposed at the DBP stage, is another risk that the Company carries. Equally, a Band A efficient company for operating costs has less scope to absorb new cost increases.

Complex treatment process example, the membrane plant at Seedy Mill Water Treatment Works

"The Company considers that the two largest risks that it faces in the future relate to income and power costs."

The Company has one of the lowest profit margins in the industry and therefore an equally sized cost or income shock (as a percentage of revenue) will have a proportionally larger impact on the returns of South Staffs Water, thereby significantly increasing the risk that the Company faces. In addition to this, as a small company, South Staffs Water has an operational reliance on two key water resources, high pumping requirements and a capital programme that can be "lumpy", reflecting the historical development of the Company, all of which introduce additional risk.

A further risk going forward relates to pension costs. The current market value of the pension fund is lower than that in March 2008. This has not been included in the FBP as a long term view has been taken. However, if the financial markets have not recovered to March 2008 values by 2011 then a sizeable contribution uplift would be required.



Thermography process - technology used to detect excessive heat, indicating potential failure of asset

10. Reasons for Changes in Customer Bills Post 2010

In this section the Company presents the summary of reasons for changes in customer bills in two ways. The first approach is in the format that Ofwat has specified, and thus this allows comparisons with the plans of other water companies. A second approach is then presented as this reveals a little more behind the underlying factors leading to changes in customer bills from April 2010.

Water quality instruments at Seedy Mill Water Treatment Works

Approach 1:

Average household bill in 2009/10			**£116**
Less	**1. past efficiency savings and outperformance**		**-1**
Plus	**2. maintaining base services**		**18**
	Of which		
	a) changes in revenue	0	
	b) changes in operating costs to maintain current services to customers	13	
	c) changes in costs of maintaining assets	2	
	d) changes in impact of taxation	1	
	e) change in the cost of capital	2	
	3. maintaining and enhancing security of supply		**2**
	4. the impact of improvements in service		**0.2**
	Of which		
	a) drinking water quality	0.2	
	b) environmental improvements	–	
	c) improvements in service levels	–	
Less	**5. scope for reduction through future efficiency improvements**		**-1**
Average household bill in 2014/15			**£134**

Approach 2:

Here the analysis focuses on a breakdown of the 5-year price increase of 16.8% presented in this business plan. The following factors are the principal drivers:

	5 year Price Impact (%)
Energy prices	7.2
Other operating cost changes – TMA, debt, pensions, abstraction costs	4.0
Cost of mains replacement activity	1.1
Extra capital maintenance of surface assets and asset revaluation	1.0
Extra customer metering	2.0
Operating cost efficiencies (past and future)	-1.6
Tax	0.8
Cost of capital	2.2
Revenue changes	0
Quality Programme – environmental schemes and security work	0.2
Total	**16.8%**

It should be noted that this FBP does not include allowances for the following issues that may need to be factored into Determinations:

- **Business rates changes** – since there is a lack of full information at this point.
- **Service premium incentives** – should our OPA (Overall Performance Assessment) remain high then there may be a service premium applicable. The Company's relative performance is unknown for the whole period and it is not confirmed how scores or ranking will be reflected in price limits.

Toughbook™ being used at Seedy Mill Water Treatment Works to gather asset information

11. Financing the Programme

COST OF CAPITAL AND SMALL COMPANY PREMIUM

Cost of capital: This FBP has included a cost of capital of 6.3%, inclusive of the effect of the small company premium. The June 2008 NERA report used for the DBP, calculated a post-tax cost of capital (WACC) range of 4.4-4.9% (exclusive of small company premium) based on market data up to March 2008. At the time of the DBP, the Company made it clear to Ofwat that the cost of capital estimate and evidence would be updated from the DBP position to reflect changing market conditions. Since mid-2008, economic conditions and financial markets have deteriorated significantly. This has resulted in higher trading volatility and the re-pricing of risk in both the debt and equity markets. Consequently, NERA's revised WACC range, based on data up until November 2008, is a range of 4.6-5.1% (exclusive of small company premium).

"This FBP has included a cost capital of 6.3%"

While the Company utilises NERA's results for this FBP, it also highlights several concerns. First, the Capital Asset Pricing Model (CAPM) and related analyses utilise extended time series of historical data. This does not take full account of the unprecedented volatility that is happening in the current downturn. While the Company acknowledges the need for data-driven analyses and accepted methodologies, stakeholders need to consider current adverse trading and financial conditions. Second, NERA's range (other than at the top of the range) supports a cost of capital below the PR04 final determination. The Company cannot endorse a reduction given that the risk profile of the industry has materially worsened. In particular, it has concerns with NERA's estimates of the risk-free rate and cost of equity, both of which are below the PR04 levels. The Company believes that higher volatility, deteriorating economic conditions and reduced creditworthiness are driving risk and the required investor returns meaningfully higher (not lower).

The Company has experienced its own difficulties in securing debt finance, at a time before the credit crunch really bedded in. Hence its experience on the pricing and protracted time taken in securing the recent Bond issue and Barclay's borrowings is relevant evidence. The index linked debt market with asset swappers led by Dexia and Detfor is now closed to new business. The effective cost on our bond included a spread over Government gilts of over 140 basis points, significantly wider than the 80 basis points being experienced by water and sewerage companies during 2007. The market has deteriorated further since the Company issued this bond in June 2008. Also, in connection with its bank facilities, the Company is being quoted renewal costs of 2.25%, significantly higher compared to historic margins of 0.5%.

A number of factors drive the higher cost of capital estimate versus the PR04 final determination. These are not limited to the increase in forward-looking debt financing costs. For example:

- Demand and income: During 2008/09, the Company has experienced a 11% decline in demand, which has resulted in £2m (9%) shortfall in measured commercial turnover;
- Power: Power prices are very volatile and represent a significant part of the Company's operating costs;
- Bad debt: After years of stability, for 2008/09, the Company projects an increase in bad debt;
- Metering: For 2008/09, the Company has experienced a 115% increase in meter optants, compared to the figure allowed for at the PR04 determination. This drives higher capital investment, reduced cash flow, and lower future demand;
- Inflation: Inflation volatility and the risk of deflation creates uncertainty;
- Carbon: The intense carbon use of the sector leads to risks of high penalties or taxes by the Government;
- Legislation: The Traffic Management Act (TMA) and Floods and Water Bill are examples of uncertainties that could lead to new cost shocks.

As a consequence of these and other developments, the Company's profits and dividends are more volatile and less predictable. Additionally, it has reduced costs to the extent that further declines in revenue would have a disproportionately adverse effect. This situation increases the level of risk the Company and others in the industry are exposed to, which limits the attractiveness of the sector to shareholders and lenders.

NERA is recommending that its cost of capital range will need to be reconsidered closer to the PR09 final determination. The Company supports this. It further encourages stakeholders to evaluate its FBP submission against the backdrop of a severe, ongoing downturn and its balanced approach to demand projections and identified notified items.

Small Company premium: The 6.3% cost of capital estimate includes the effect of a small company premium, in line with NERA estimates. The Company believes that a SCP should be included to reflect the higher cost that water only companies face for debt and equity compared to the larger water and sewerage companies. This accounts for the access to more limited, less competitive sources of finance, higher operational risks and higher liquidity and refinancing risks. The Company's view is supported by the rating agencies and NERA, who in its March 2009 report, addresses questions previously raised by Ofwat with respect to the need for a small company premium.

"The 6.3% cost of capital estimate includes the effect of a small company premium."

GEARING AND DIVIDEND POLICY

The Company's policy is to pay dividends that maintain the level of debt to Regulated Capital Value at 77%. The Company will ensure it has sufficient financial resources available for it to operate and an appropriate headroom is maintained against covenants in its bond and bank borrowings. There are also incentives to improve efficiency, to control debt levels and to generate cash. These incentives ultimately benefit customers and contribute to the Company's profitability.

Rapidly changing inflation during 2008/09 has adversely affected our capital structure. The Company has inflation linked debt to reflect the fact that changes to revenues and regulated capital value are linked to changes in inflation. However, the Company's index linked debt has increased by 5% for the year ending 31 March 2009 (based upon inflation in July 2008), whereas RCV is not expected to increase in real terms due to an expectation of nil inflation in March 2009. This mismatch in inflation has resulted in increased volatility in returns and the ability to pay dividends.

MOVEMENT IN REGULATORY CAPITAL VALUE

The Company has the lowest RCV in the sector, relative to size. Assuming the full £140m capital programme is allowed in the Determination the RCV growth is only modest, rising from £207m to £219m by 2015.

CURRENT COST DEPRECIATION

The Company has carried out a full revaluation of its asset base as part of the PR09 process which was applied from 2008/09. Total Net MEA for depreciable assets has remained unchanged, with the impact on CCD being a small increase. The Company believes that the difference between MNI and CCD over the 28-year period from 1998 to 2025 is within a 5% tolerance and so does not expect any adjustment to be made to Price Limits.

12. Overall Final Business Plan Price Limits & Forecast of Customer Bills

This business plan forecasts the following price limits (K factors), which represent the annual percentage change in customer charges anticipated as necessary:

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Price Limit (% change)	1.3	8.1	4.4	4.2	0.1	0.0
Average Household Bill*	116	125	130	135	135	134

*Customer bills are shown in 2007/08 price base, excluding inflation.

This gives an annual average change in price limits of 3.4% in the period 2010-15, totalling 16.8%.

Over the next 5 years (2010/15), the average household bills for South Staffs Water customers will rise in total by 15.5%, excluding inflation, a total increase of £18 per household, which is £3.60 per year. Our current average household bill of £116 is therefore expected to be £134 in 2014/15. This increase in household bills is slightly lower than the proposed price limits as a result of some customers benefiting from taking up the option to have a meter installed.

The profile of price limits in this FBP is different to the DBP that was submitted in August 2008. In response to feedback from Ofwat and CCWater, the year 1 price limit is much lower and the Company has also re-profiled the price limits to bring forward what was originally a negative K factor in the later years.

13. Further Information

NEXT STEPS AND TIMETABLE FOR THIS REVIEW

The major milestones for the remainder of this periodic review are as follows:

Ofwat issue Draft Determination	23 July 2009
Company and Stakeholder Representations	September 2009
Ofwat issue Final Determination	26 November 2009
Company decision on whether to appeal to the Competition Commission	January 2010
Price Limits become effective	1 April 2010

GLOSSARY

It is recognised that some of the wording in this document is technical as it applies to the terminology used in the regulatory environment within which the Company operates. If you wish to see a glossary of the technical terms and acronyms used in this document please **click here.**

LINKS TO OFWAT PRESCRIBED TABLES

Table No.	Title	Link
-	One page summary	**Click here for summary**
A1	Price limits, bills, water sales, supply / demand balance	**Click here for A1**
A2	Current performance & planned outputs	**Click here for A2**
A4	Key activity projections	**Click here for A4**
A6	Efficiency improvements	**Click here for A6**
A7	Expenditure projections	**Click here for A7**
A9	Financial projections – public domain	**Click here for A9**
A10	Summary of justification of company investment proposals	**Click here for A10**

Alternatively, for a pdf file containing all the above tables, **click here.**

For Part A Table and Line Commentaries, **click here.**

LIST OF ATTACHMENTS / SUPPORTING DOCUMENTS

This document has aimed to focus on the high level issues, but we recognise that at times it may be necessary to review issues in further detail. Hence the structure of this document has allowed readers to decide if they wish to explore issues in further detail. A full list of the various documents signposted in this paper is shown in the table below:

No.	Supporting Material Available
1.	**Strategic Direction Statement – long term strategy published Dec 07**
2.	**Governance and Company Ownership of Business Plan**
3.	**Glossary**
4.	**Company Background**
5.	**Willingness to Pay results presentation**

CONTACT FOR FURTHER INFORMATION OR TO EXPRESS OPINIONS

Further information is available on a website created specifically for this business plan.

Please visit: **www.sswbusinessplan.co.uk**

To obtain further information on the Company's business plan or for clarification on any matters in this report please email or write to:

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Walsall WS2 7PD.

Email: **evagreenfield@south-staffs-water.co.uk**