

November 2016

Trust in water

# Company monitoring framework

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2016 assessment

Individual company report – Southern Water Services Ltd

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## Company monitoring framework assessment

This document outlines the results of our 2016 Company Monitoring Framework (CMF) assessment of Southern Water's assurance. It includes a summary of our assessment, and further information on the exercises we undertook to assess Southern Water's assurance, and our findings.

In the context of our CMF, in order to be in the self-assurance category, we were looking for leading edge companies to meet the high standards of assurance that stakeholders expect. As well as providing clear, transparent and accurate data, we expect companies to present their information in a way that stakeholders can engage with. We were looking for companies who can demonstrate a successful and positive approach to stakeholder engagement, including in their approach to developing their assurance plans where appropriate. Transparency about company structures, procedures and decision-making processes is another important area of focus that helps companies to earn their stakeholders' trust and confidence.

Further information on this year's assessment is available in our '[Company monitoring framework 2016 assessment](#)' publication. The framework itself is available in our '[Company monitoring framework final position](#)', published in June 2015.

### Summary of our assessment

Southern Water has broadly met our expectations in around half of our assurance assessments. However, we also identified two serious concerns, and four minor concerns, with Southern Water's assurance. Our concerns related to most aspects of assurance – data quality, transparency, board governance and narrative explanations for stakeholders.

To change the category of a company from 'targeted' to 'prescribed' assurance, we would need to have seen behaviour leading to a reduction in the trust and confidence that stakeholders can place in it. Our view is that Southern Water has a pattern of 'minor concerns', which together with two 'serious concerns', demonstrates such behaviour. **We have therefore decided to change Southern Water's assurance status to 'prescribed'.**

In this document we have set out a brief summary of the individual assessments that we undertook as part of our Company Monitoring Framework (CMF) assessment in

2016. The remainder of this document provides brief feedback on the company's performance against each of our eleven assessment areas for this year:

| <b>Our view</b>    | <b>Assessment</b>   |
|--------------------|---|
| Meets expectations | Financial monitoring framework  |
| Meets expectations | Charges schemes assurance   |
| Meets expectations | Financial information   |
| Meets expectations | Final 2010-15 reconciliation data submission                                |
| Serious concerns   | Outcomes  |
| Minor concerns     | Compliance with principles of board leadership, transparency and governance |
| Minor concerns     | Risk & compliance statement   |
| Meets expectations | Assurance plan  |
| Minor concerns     | Targeted reviews  |
| Minor concerns     | Data assurance summary  |
| Serious concerns   | Evidence from casework activities   |

## Results of each assessment exercise

### 1.1 Financial monitoring framework

#### What we were looking for

In this assessment we looked at how the companies had followed our financial monitoring framework guidance. Our assessment focused on the quality of financial information published in the annual performance report, the transparency of disclosures and consistency of financial metric data published.

This is an area where companies' data assurance is particularly important, and companies need to ensure that the information that they publish is in line with the guidance provided by Ofwat. This enables Ofwat, and other stakeholders, to be confident that the information that each company publishes has been prepared on a consistent basis and allows meaningful comparisons to be made between companies.

#### What we found

Our review identified that improvements could be made to the company's disclosures in relation to the disclosure of net debt. In addition the dividend metrics reported were calculated by reference to the statutory accounts not the regulatory accounts, but on balance these errors were not considered to be serious.

Our assessment: **meets expectations**

## 1.2 Charges schemes assurance

### What we were looking for

Companies must publish their forward charges schemes in February each year. We checked that companies:

- published and assured their charges schemes;
- complied with our charging rules;
- assessed and explained significant movements in charges; and
- devised and put into effect effective handling strategies to address significant movement in charges.

This is an important assessment, because our charging rules are designed to protect customers through stable, transparent and predictable charging, in the absence of competition.

### What we found

Overall Southern Water demonstrated that it followed our guidance, and the quality of data and the transparency of the published information met our expectations. The company could have been more specific about its engagement with CCWater on the incidence effects of the changes in charges and the associated handling strategies, but this did not impact the overall assessment.

Our assessment: **meets expectations**

## 1.3 Financial information

### What we were looking for

In this assessment we looked for an absence of omissions or errors, where the companies reported their actual performance and to compare aspects of this performance to the assumptions made at the PR14 final determination. We did not look at all areas but chose four key risk areas to look at this year which were:

- wholesale total expenditure reporting;
- revenue and profit statements, disaggregated by price control;
- methodology statement on how costs are allocated across the price controls; and
- disclosures required for transactions with non-regulated associate companies.

We developed a log of the issues, errors and inconsistencies we uncovered as part of our analysis. We assessed the nature and number of issues identified to form a view on the quality of assurance in each company's published financial information.

This is an area where companies' data assurance is important, because a range of stakeholders will use this information and rely on its accuracy. It also informs important preparatory work for PR19.

## **What we found**

We identified no issues during our review of the four areas we chose to look at this year.

Our assessment: **meets expectations**

## **1.4 Final 2010-15 reconciliation data submission**

### **What we were looking for**

In this assessment we assessed companies' adherence to our guidance ([IN15/17](#), December 2015) covering assurance, data and commentary requirements. Our guidance covered a range of requirements including data table completion, explanatory requirements, supporting evidence and board signoff.

This is an important area for companies' data assurance, because the submission is used to update the final reconciliation of the PR09 incentive arrangements for the 2010-15 period which directly impact the companies' revenue allowances they can recover from customers.

## What we found

Overall we have no concerns with the assurance of the final 2010-15 reconciliation submission. The company met our expectations for the submission in respect of all the elements that are relevant to the company.

We noted minor data ambiguities in and across tables which when queried were easily corrected and we considered them to be in part a consequence of interpreting our guidance in a not unreasonable way. However there was insufficient level of detail provided in the initial commentary to allow us to assess the RCM and change protocol. Consequently we raised a number of queries seeking to clarify our understanding of the information provided in the submission which the company resolved proactively to our satisfaction.

Our assessment: **meets expectations**

## 1.5 Outcomes

### What we were looking for

In this assessment we looked for

- reliable, timely and appropriate information for customers and other stakeholders;
- Transparent and accessible information for customers and other stakeholders;
- appropriate data assurance;
- evidence that the company has listened and responded to its customers and other stakeholders; and
- compliance with the outcome delivery and reporting proposals as set out in the PR14 final determination company-specific appendix.

This is an important assessment, to ensure that stakeholders can understand what companies are doing to deliver the outcomes that customers expect.

### What we found

For most of their performance commitments, Southern Water has provided accurate, reliable information in table 3A (outcome performance) and its annual reporting commentary.

Overall, the company has provided evidence that it has been transparent with customers and stakeholders about the data assurance that has been put in place. For example, the company's website contains a statement from its independent technical assurer, Halcrow Management Sciences Limited; this provides customers and other stakeholders with assurance that the assessment of the company's performance has been reviewed by an independent technical auditor who has challenged the company's data, methodologies, processes and supporting evidence and ensured objective reporting.

There is clear evidence that the company has provided the wider assurance to demonstrate it is listening to customers. The company has established an independent Customer Advisory Panel (CAP) to monitor delivery of their business plan promises and advise the Board on key business issues from a customer perspective. The Customer Advisory Panel Report 2015-16, published on the company's website, provides customers and other stakeholders with an independent opinion on the company's progress in delivering its performance commitments.

Overall, the company's reporting is transparent and accessible to customers and other stakeholders. The company's website and annual report contains well-presented, clear and easy to understand performance information. However, there are a number of material instances where we have concern:

Firstly, there is an instance of a committed performance level (CPL) that has not been met and the company has explained the cause to ourselves (Ofwat). Within the Annual Report, the company has provided an explanation of the performance issue and explained how it will be addressed in the best interests of customers, but the commentary around the cause of the performance issue is less comprehensive.

Secondly, the company provided commentary on its five reputational performance commitments (PCs) measured by customer surveys. It has also explained to us that, following discussions with the Customer Advisory Panel (CAP) and an independent expert, they have changed their survey questions. The survey questions that were published in the PR14 final determination company-specific appendix are no longer being used and therefore the company is unable to follow the dual reporting process described in Information Notice IN 16/07 (changes to outcomes in the 2014 price review company-specific appendices, published May 2016). In the Information Notice we say "Our decisions on outcomes, PCs and ODIs at PR14 are final".

We have serious concerns that:

- Southern Water did not alert us that it was proposing to change five of its PR14 performance commitments until 18 months after final determinations; and

- Southern Water has made it impossible to return to the PR14 performance commitments by dropping the questions they were based on from its survey.

Southern Water refers to the Information Notice being published after the company had developed and sent out the revised survey questions. This has no bearing on our assessment as it was clear to all parties at PR14 that the final determinations were final and companies could not change their commitments to their customers and the regulator unilaterally.

We recognise that Southern Water, its CAP and its consultants consider that the original PR14 measures had issues, such as a lack of clarity and a high proportion of “don’t know” responses, which meant they would not provide particularly useful information. We also recognise that Southern Water’s CAP has been involved in changing the survey questions which the company, its CAP and its consultant consider to be clearer for customers and an improvement. We acknowledge that dual reporting similar survey questions might be wasteful of customers’ time and the company’s money. However, this illustrates that five of the company’s original performance commitments in its business plan, which were translated into its PR14 company-specific appendix were not robust - an issue which we were not aware of at the time. In addition, Southern Water should have addressed this issue with us much earlier.

Our assessment: **serious concerns**

## **1.6 Compliance with principles of board leadership, transparency and governance**

### **What we were looking for**

In this assessment we looked for how the information which the company provided demonstrated that it has met our board leadership transparency and governance principles. This included the provision of:

- transparent governance information, including group structure and on director remuneration;
- evidence that the board of the regulated company has full control over the company, including its long-term strategy, and is fully focused on its obligations; and
- clear information on the composition of the board and its sub-committees.

This is an important assessment, designed to give stakeholders trust and confidence that the company is structured appropriately and transparently, and complies with its legal obligations.

## **What we found**

The information provided in the company's annual reporting has demonstrated that it has met most of our board leadership transparency and governance principles.

However it has not provided an explanation as to how its chairman's independence is not undermined by him also chairing a holding company. Given the nature of the group structure within which Southern Water Services operates, the chairman's role does not necessarily raise any particular issues in practice but a lack of transparency could undermine the confidence stakeholders have in the board leadership and governance of the company.

While the company has provided a clear group structure diagram it would have helped improve transparency for all stakeholders if it had set out the role of different companies within the group structure.

Our assessment: **minor concerns**

## **1.7 Risk & compliance statement**

### **What we were looking for**

In this assessment we looked for a statement, explicitly endorsed by the company's board, which confirms that the company has complied with all its relevant statutory, licence and regulatory obligations and is taking appropriate steps to manage and/or mitigate any risks it faces.

This assessment is designed to give stakeholders trust and confidence in companies' approach to compliance and risk management. The statement is intended to facilitate a company-led approach to compliance.

## What we found

The company has provided a clear statement that it has complied with all its relevant statutory, licence and regulatory obligations. The statement refers to how it is managing risk but there is no direct statement from the board that the company is taking appropriate steps to manage and/or mitigate any risks it faces. The statement is only signed by the chief executive and therefore it may not be sufficiently clear to all stakeholders that it has the endorsement of the whole board. Additional sign off by an independent member of the board would help add legitimacy for stakeholders.

Our assessment: **minor concerns**

## 1.8 Assurance plan

### What we were looking for

In this assessment we looked for the following in companies' assurance plans.

- Explanation of the framework and their approach to it.
- Evidence of stakeholder engagement undertaken to develop the plan.
- Clear scope, and rationale for targeting specific areas.
- Appropriate language and accessibility for all stakeholders.

This is a key test of whether companies are listening to their stakeholders and using their views to improve their practices.

### What we found

The company provides a clear overview section setting out the context for the plan and the work done to date. The assurance plan contains a comprehensive appendix setting out more detail on company's framework and approach to assurance. The plan demonstrates there has been good stakeholder engagement, highlighting where the company has amended its draft plan as a result of stakeholder feedback. Though brief, the plan clearly sets out the targeted areas. More detail around planned assurance activities on the targeted areas would have improved the statement.

We are supportive of company's approach to further enhance future reporting for stakeholders.

Our assessment: **meets expectations**

## 1.9 Targeted reviews

### What we were looking for

In this assessment we looked at:

- companies' tax reconciliation notes published in the annual performance report to see if they acted on our tax targeted review recommendations; and
- improvements companies have made to 2015-16 reporting in response to our sludge and water resources targeted review.

These are two areas we have recently highlighted for companies to focus on, and we want to see evidence that they are taking steps to improve their assurance.

### What we found

The tax reconciliation note published in the annual performance report details that no tax was allowed in the PR14 final determination but an actual current tax charge was reported. The company should have provided narrative to explain why/how this tax charge has arisen when not forecast to do so, quantifying each difference.

The published cost allocation methodology statement clearly set out the changes made for 2015-16 reporting as a result of the CEPA recommendations made following our targeted review into sludge and water resources.

Our assessment: **minor concerns**

## 1.10 Data assurance summary

### What we were looking for

We checked that companies have:

- published a data assurance summary for 2015-16 activities;
- covered the targeted areas from the company's assurance plan; and

- provided an overview of the company's assurance methods and processes, the audit exercises carried out and their findings.

This assessment is designed to ensure that companies provide accessible assurance to stakeholders, to build trust and confidence in their data publications.

## What we found

The company published a brief summary of the data assurance carried out for the annual performance report. To gain a full perspective, the data assurance summary needs to be read in conjunction with other sections of the Annual Report which are referenced in the summary table. We do not consider this to be a user-friendly format for stakeholders.

The data assurance summary is written in a technical style that assumes the reader is knowledgeable and well informed about assurance practices and the water sector context. Being bound in the annual performance report, it is not prominent on the company's website and there are no search results for "data assurance". This is not helpful to stakeholders trying to access this information.

Our assessment: **minor concerns**

## 1.11 Casework

### What we were looking for

In this assessment we looked at companies' responses to cases from 1 April 2015 onwards. We considered the company's response to our requests for information. We checked that companies had provided complete, accurate information within our timescales, and engaged effectively with us.

This assessment focused on our trust and confidence in companies' information provision, and complemented the other assessments that focused on information published by companies.

## What we found

We have opened three cases concerning Southern Water since April 2015. Two of those cases, which have since been closed, were determinations under section 45 of the Water Industry Act 1991. In one of the cases, on two separate occasions, Southern Water forgot to respond to our requests for information and we subsequently had to follow these up with Southern Water. In the other case, the information provided by Southern Water was clear, however, it was not provided within the deadline and, as in the other case, we had to follow this up with Southern Water. The remaining case is a determination under section 99 of the Act and this case is currently open. In this case, Southern Water has responded to our requests for information in a timely manner but we have had to go back to Southern Water seeking clarification and additional information as the responses have been very technical and not sufficiently clear. Overall, the company has not provided us with timely, complete and accurate information and this has not given us the trust and confidence required in this area.

Our assessment: **serious concerns**