

January 2019

Trust in water

# **Company monitoring framework: 2018 assessment Individual company report – Southern Water**

## Company monitoring framework assessment

This document outlines the results of our 2018 company monitoring framework assessment of Southern Water's assurance. It includes a summary of our assessment, and explains how we assess the company's assurance, and our findings.

In the company monitoring framework (CMF), we are looking for evidence that companies are meeting the high standards of assurance that stakeholders expect. We consider whether companies are providing clear, transparent and accurate data, and we assess the way companies present information to customers and other stakeholders. We also look at how transparent companies are in explaining, company structures, decision-making processes or any performance issues. For 2018 we also considered under the company monitoring framework data quality and consistency in company business plans submitted as part of the price review.

Further information on this year's assessment is available in our '[Company monitoring framework 2018 assessment](#)' publication. The framework is available in our '[Company monitoring framework final position paper](#)', which we updated in June 2018.

### Summary of our assessment

Considering the issues in the round, **we have decided to retain Southern Water in the 'prescribed' assurance category.**

We have looked at how well the company has performed against the expectations we have set for each of our assessments, including whether they have:

- met or exceeded our expectations by a clear margin,
- demonstrated leading edge behaviour, and
- displayed behaviours that could lead to a reduction in trust and confidence.

We have also considered any other issues or information relevant to the confidence that can be placed in the company's information in making our overall assessment,

Whilst the company met our expectations in some areas, we had minor concerns in three areas (financial flows, cost assessment and business plan data consistency) and serious concerns in two areas (water resources management plan and casework), and we noted two issues relating to wider assurance and information.

Taking all of this into account, while there are examples of good practice, we found a pattern of behaviour that does not instil sufficient confidence in the information that it publishes and provides to stakeholders.

In this document we have set out a brief summary of the specific assessments that we undertook as part of the company monitoring framework in 2018.

## **Results of our assessment**

### **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**

Overall the company has met our expectations in relation to financial monitoring. Southern Water has followed our guidance, and the quality of data and the transparency of the published information met our expectations in many areas. We raised two queries to obtain clarification on the financial metrics disclosed in its Annual Performance Report (APR) for reconciling the net debt figures provided. These clarification queries were not assessed to have had an impact on the overall confidence in the information presented.

Our assessment: **meets expectations**

## 1.2 Charges engagement

### What we were looking for

We have to date issued three charging rules: Charges Scheme Rules; Wholesale Charging Rules; and Charging Rules for New Connection Services (English undertakers). Each of these ‘charging rules’ require companies to publish a document in which they set out their charges relating to these rules. Their publications are charges schemes, charges schedules and charging arrangements respectively.

For this assessment, we focus on how well companies have engaged with their stakeholders about their charges and charging policies through their publications and actual interactions. We based our assessment primarily on the documents that the charging rules require companies to publish or submit to us, as per [IN17/09](#), including but not limited to:

- the published charging documents;
- Board assurance statements;
- assurance of the engagement on and publication of charges information, where appropriate under the charging rules;
- the information companies provide in their Statement of Significant Changes; and
- the handling strategies companies devise and put in place to address significant movements in charges.

In certain cases, we supplemented the information by submitting queries to some companies, looking more widely at material published on company websites, and cross-checking against customers’ and stakeholders’ comments or complaints regarding charging.

This year our assessment has included new connection services charging rules for companies wholly or mainly in England, which came into force in April 2018, for the first time.

### What we found

The company met our expectations. Southern Water’s assurance statement contained useful detail, including a breakdown of how compliance had been achieved against each specific rule. There was a reasonable level of information

relating of stakeholder engagement, including pro-active engagement with retailers and relevant parties in relation to new connections. There was good evidence of timely and effective consultation with the Consumer Council for Water with dates of meetings and topics discussed.

The company's new connections charging scheme was clear and accessible. It would be useful to have worked examples or other tools to help customers estimate their bills

In common with most companies, we expect the company's explanations of how charges are derived, consistent with the rules, to be improved next year.

Our assessment: **meets expectations**

## 1.3 Outcomes

### What we were looking for

We want to ensure that stakeholders understand company performance to deliver the outcomes that the company committed to deliver at PR14. This year our assessment focused on the availability and accessibility of published performance data and how that information is communicated to stakeholders. We expect companies to be transparent, provide accessible information for customers and other stakeholders and show that they have listened and responded to their customers and other stakeholders.

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

This year our assessment did not include the quality of companies' *assurance* over published data, in order to avoid duplication with the data consistency and data quality assessments in the initial assessment of company business plans (see sections 1.11 and 1.12).

### What we found

Southern Water has met our expectations for this assessment. There is sufficient evidence that the company's reporting is transparent and accessible to customers and other stakeholders. Southern Water has published performance information in

its Annual Performance Report 2017-2018 (APR) and its Annual Report and Financial Statements 2017-18. These can be accessed using the 'About us' link on the homepage, then navigating via the 'Our publications', 'Our reports' and 'Our annual accounts' links. In addition, the 'Annual report' link on the home page provides helpful interactive summary information, together with links to download the 'Annual Report and Financial Statements 2017-18' and 'A quick summary of our performance 2017-18' document. The Annual Report & Accounts and Annual Performance Reports for earlier years are available on the 'Our annual accounts' web page.

Our assessment: **meets expectations**

## **1.4 Water resources management plan and market information**

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

Companies are required to produce a water resources management plan every five years setting out their approach to maintaining the long-term supply and demand balance in a way that delivers best value for customers and the environment for the next 25 years. We review and provide comments on draft water resources management plans to Defra and the Welsh government, in our capacity as a statutory consultee.

Our assessment in the company monitoring framework considered the quality of the information in companies' draft water resources management plans for the period 2020 to 2025. The assessment considered the quality of data and internal consistency in the plans, the extent to which stakeholders had been involved in the development of the plans, how clearly plans have been communicated to stakeholders and evidence of assurance of the plans. The assessment also considered the quality of the water resources market information published by the company. In that respect, the assessment considered the quality and completeness of the data, the clarity of its presentation and its consistency with the company's draft water resources management plan.

This is the first time that water resources management plans and market information has been included within the company monitoring framework.

## What we found

Overall, we had serious concerns in key areas of this assessment such as options costing, Board involvement, assurance and leakage reduction presentation. The draft water resources management plan option costs were not presented clearly and a limited description of assurance was provided for both the plan and market information table. The late provision of the market information and the time taken to update option cost information did not provide confidence in the company's management of this data. The leakage reduction target, a key plan metric, was not consistently presented in the plan and there was no evidence of Board involvement or sign off.

Our assessment: **serious concerns**

## 1.5 Long-term Viability Statement

### What we were looking for

This assessment focused on the transparency and assurance on companies' long-term financial resilience as set out in their long-term viability statements.

This assessment is important in providing Ofwat and other stakeholders with assurance that companies have the long-term financial resilience to meet the needs of consumers in the long-term.

The assessment considered the extent to which companies have followed our guidance for issuing long term viability statements as set out in [IN18/04](#) and in particular the approach they have taken to assessing their long-term financial viability. The assessment considers how their long-term financial viability statement linked to their wider risk assessment including mitigating actions, the extent to which companies have stress tested their projections, whether they have clearly explained their approach and the evidence of assurance over the process.

This is the first time that information on the long-term viability statement has been included as a separate category in the company monitoring framework (last year it was included within the “financial monitoring framework”).

## What we found

Overall Southern Water met our expectations for the long-term viability statement included in the Annual Performance Report, through clear signposting to the Annual Report and Financial Statements. The directors have provided a statement that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the five year period ending 31 March 2023, clearly setting out the approach to the assessment and the basis for the period reviewed.

The risk management process has been clearly set out with reference to the risk appetite and the changes to the principal risks. The principal risks facing the company have been individually identified with the potential impacts stated alongside the mitigating actions to be taken by the Board with timelines for implementing the actions included. The company has clearly set out the key assumptions underpinning the sensitivities used within the scenario testing. There is evidence of the combined scenarios they have tested with an explanation of how they were developed included. The company has concluded the viability of Southern Water was not compromised by the individual or combined scenarios. However, more explanation could have been given on the impact of the scenarios on debt covenants and credit ratings.

The company has set out the assurance undertaken on the assessment of long term viability within the statement by signposting the strategic report and corporate governance. They have stated a third party assurer has been used to test the calculations and sensitivities to the financial projections though the report is not signposted.

Our assessment: **meets expectations**

## 1.6 Financial Flows

### What we were looking for

The requirement for companies to submit financial flows covering the periods 2015-16, 2016-17 and 2017-18 is one of the key ways in which we are improving the transparency of financial flows to investors.

In our assessment, we focused on companies' compliance with the requirements of [IN18/08](#) in terms of data quality and assurance as well as how meaningful the data and supporting commentary is to stakeholders.

This is the first time that information on financial flows has been included within the company monitoring framework.

## What we found

We have minor concerns in this area due to a number of concerns over the accuracy of the data and how the company has interpreted our guidance, which required querying more than once for some areas. The company published its 2017-18 financial flows in its Annual Performance Report and had this externally assured. Data for the other two years was not published and there was no evidence that it had been assured.

Our assessment: **minor concerns**

## 1.7 Risk & compliance statement

### What we were looking for

This assessment is designed to test our confidence in companies' approach to compliance and risk management. The risk and compliance statement is intended to facilitate a company-led approach to compliance.<sup>1</sup>

Our assessment looks 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.

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<sup>1</sup> Our findings here, and throughout our company monitoring framework assessment, are without prejudice to any issues that we may investigate under our enforcement powers and subsequently find wanting. It would be inappropriate to pre-empt the outcome of any investigations that might consider whether the assurance provided is indeed appropriate or accurate. Any adverse findings in this respect may be taken into account in future assessments.

This year we have also taken into account relevant information provided in companies' annual reporting to ensure that they are consistent.

## What we found

The Board has provided a clear statement confirming that the company has an understanding of, and is meeting, its obligations. It has also confirmed that the company has sufficient processes and internal systems of control to meet those obligations and has systems and processes in place to identify, manage and review its risks. The statement has been appropriately signed off on behalf of the Board.

Our assessment: **meets expectations**

## 1.8 Assurance plan

### What we were looking for

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

- explanation of the assurance framework and their approach to it;
- evidence of stakeholder engagement undertaken to develop the plan;
- clear scope, and rationale for targeting specific areas; and
- 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's assurance plan met our expectations. The company discusses its assurance plan in the context of the associated risks, strengths and weaknesses statement which precedes the actual plan. This provides a clear context and purpose. A detailed description of stakeholder and customer engagement and how they have been reflected in the plan is outlined. The plan includes a detailed table setting out actions under their three lines of defence model. The level of detail in the plan recognises the requirements for a prescribed company.

Our assessment: **meets expectations**

## 1.9 Cost assessment

### What we were looking for

Our assessment focused on the assurance of cost assessment data submitted in the annual performance report. The assessment of efficient costs is a key element of setting price controls. We need good quality, consistently reported cost assessment data to do this effectively. This year's assessment considered the completeness and accuracy of the cost assessment data, allocation of costs and assurance over data. It also considered how meaningful the data and supporting commentary is to stakeholders.

This is the first time that cost assessment has been included as a separate category in the company monitoring framework (last year it was included within "wider assurance and information").

### What we found

We had minor concerns in this area. Whilst all cost assessment tables were complete with no missing data, we identified some significant variances from historical trends which we had to raise queries to the company on due to insufficient commentary and explanation. The Accounting Separation methodology statement was available but we had concerns about assurance (no evidence of external assurance) and cost allocation methods.

Our assessment: **minor concerns**

## 1.10 Casework

### What we were looking for

This assessment relates to the information that companies provide to us when we engage with them to carry out our investigation and enforcement functions. We looked at companies' responses to cases from 1 April 2017 onwards. We considered companies' responses 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 confidence in companies' information provision, and complemented the other assessments that focused on information published by companies.

## What we found

We closed two cases concerning Southern Water during the assessment period, a new connection determination and a trade effluent appeal. We currently have four open cases – an enforcement case, a sewer requisition case and two requests to appoint an arbitrator.

We have not provided an assessment with regards to the requests to appoint an arbitrator as we did not request any information from Southern Water during the assessment period. We have also not provided an assessment with regards to the closed new connection determination as we included an assessment of this case in last year's assessment.

We consider Southern Water met our expectations regarding the sewer requisition case but we had minor concerns regarding the trade effluent appeal where the company did not respond to one of our requests for information on time.

In terms of the enforcement case, we do not consider that the company has met our expectations and we have serious concerns. This is based on Southern Water not responding fully to our requests for information (for example, by providing documents with missing pages and/or text), not responding in a timely manner and providing relevant information that was unclear. This has affected our ability to rely on the information provided and has required us to take steps to seek further clarifications and grant extensions to previous deadlines for responses, impacting our ability to progress the investigation as quickly and efficiently as we would have liked.

Our assessment: **serious concerns**

## 1.11 PR19 Initial assessment of business plans – data consistency

### What we were looking for

In September 2018, companies provided us with their business plans for the 2020-25 period. Our initial assessment of business plans tests how companies have met our expectations and requirements for meeting the needs of customers. The initial assessment incentivises companies to submit high quality, ambitious and innovative business plans. The quality of companies' information, and their track record on assurance are important parts of a high quality business plan

As set out in our '[Company monitoring framework final position paper](#)', updated in June 2018, we take account of how companies' business plans have performed against our initial assessment tests on data quality and assurance as part of our 2018 company monitoring framework assurance categorisation. The relevant parts of the initial assessment tests are confidence and assurance tests 5 which covers data consistency (considered here), and test 6 which covers data quality (covered later). The full scope of test 5 is:

“To what extent does the company have a good track record of producing high quality data taking into account the company's data submission, assurance process and statement of high quality, and our 2018 assessment of the company under the company monitoring framework?”

In our company monitoring framework assessment we have focused on the elements related to data consistency and not included the initial assessment of business plan element related to the company monitoring framework to avoid double counting.

### What we found

We found minor issues overall with the consistency of performance and financial data reported in the company's business plan tables with previous data submissions. We identified inconsistencies between the company's business plan tables and Annual Performance Report in the areas of outcomes, cost assessment and external communications and also minor omissions of actual data in outcomes.

Our assessment: **minor concerns**

## 1.12 PR19 Initial assessment of business plans – data quality

### What we were looking for

This section considers confidence and assurance test 6 which looks at:

“How consistent, accurate and assured are the company’s PR19 business plan tables, including the allocation of costs between business units, information on corporation tax, and the assurance and commentary provided?”

### What we found

Overall the business plan provides sufficient and convincing evidence that its PR19 business plan tables including the allocation of costs between business units, information on corporation tax and the assurance and commentary provided are consistent, accurate and assured.

We identified some issues with financial modelling, outcomes and risk and return data tables. We also identified an inconsistency in the business plan as the Fawley Desalination plant scheme is referred to as a potential direct procurement for customers’ scheme in the company’s narratives but not in its business plan tables. However, these issues were not considered to have had an impact on the overall confidence in the company’s business plan data quality.

Our assessment: **meets expectations**

## 1.13 Wider assurance and information

### What we were looking for

This assessment considers any information produced by the company – across a range of publications, regulatory submissions and bilateral engagement – that could potentially impact on confidence and that we therefore considered relevant to our overall decision. In carrying out this assessment, we consider the context in which any relevant information was published or shared.

## What we found

This year, for the first time, all companies were required (as set out in [IN18/07: Expectations for monopoly company annual performance reporting 2017-18](#)) to provide a performance statement, setting out how the company is delivering for the stakeholders that rely on its services and how its aspirations have been shaped. In our assessment we considered whether or not the company had provided this statement, and whether it was compliant with the requirements of IN18/07.

The company did not provide this statement. While relevant information has been provided across its annual reporting, this is not in the form of a short statement as requested in IN18/07.

We also identified an issue with respect to the company's restatement of revenues between retail and wholesale for 2015-16 and 2016-17. This has resulted in issues reconciling data under past delivery (WRFIM) and some customers have been overcharged. As wholesale revenue was under reported, wholesale tariffs were set to recover some of this under recovery, as this was driven by the error they have actually over recovered. The company have provided some information regarding how the error occurred. Whilst they have been open and transparent in raising and explaining the issue to us, there has been no mention of any communication with customers. The error was not picked up by their external auditors.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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