

January 2019

Trust in water

PR19 initial assessment of plans: Southern Water company categorisation

About this document

In '[Delivering Water 2020: Our final methodology for the 2019 price review](#)' (the methodology) we said that we wanted all 17 regulated water and wastewater companies to produce high-quality, ambitious and innovative business plans, pushing forward the performance and efficiency of the sector for customers. To encourage this we developed the initial assessment of business plans (IAP) process. The IAP was designed to incentivise all companies to produce well-evidenced plans that reflect their customers' preferences and priorities and are efficient.

We explained that the IAP would:

- assess company business plans against nine key test areas that reflect our PR19 themes and the strategic policy statements of the UK and Welsh Governments and help make sure companies deliver for customers, the environment and wider society;
- assess company business plans against three key characteristics (quality, ambition, and innovation); and
- categorise company business plans into four categories (significant scrutiny, slow-track, fast-track, or exceptional).

Following the submission of companies' business plans on 3 September 2018, we have carried out an extensive and detailed review of these plans. This review has been carried out in accordance with our methodology. More details on our overall approach to the initial assessment of business plans and our key findings by test area are set out in the 'PR19 initial assessment of plans: Summary of test area assessment'. The results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation'. Our assessment is based on the information the company submitted to us as part of its business plans for the period 2020-25. The documents we have published are available on our [website](#).

This document sets out our assessment of Southern Water's business plan submission under the IAP. It explains our assessment of the company plan in the round at an aggregate level and sets out a summary of our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the 'Southern Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Southern Water categorisation

Our assessment of the plan

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet the needs of future customers and protect and improve the natural environment. We indicated in our PR19 methodology that the bar is high, and our Initial Assessment of Plans is the categorisation of company plans against those high expectations at this stage of the price review process. Where our expectations have not been fully met, we will continue to work closely with companies towards the draft and final determination stages.

In its business plan, Southern Water acknowledges “historically poor performance and recent failings, which have fallen short of the expectations of our customers, regulators and other stakeholders”. The company also acknowledges the substantial improvements required, launching a restructure in early 2017 and saying “we strive to fundamentally change the way we work both as a company and with our regulators”. We acknowledge and welcome the work being undertaken by Southern Water to transform the way it delivers for customers.

We have placed Southern Water in the significant scrutiny category. This categorisation was made after an in the round consideration of our assessment of Southern Water’s business plan across the nine test areas and the overall level of intervention in the plan required to protect the interests of customers. Our grades for each of the test areas are set out in Table 1 below.

While Southern Water’s plan falls significantly short of high quality in a number of areas, which we detail below, there are some high quality elements. For example, it performs well on affordability, proposing a sector leading performance commitment to track the effect of the support it gives to customers who cannot afford their bills and there is strong evidence of it working with third parties including innovative partnerships with the Environment Agency and the National Farmers Union to deliver its catchment strategies.

Southern Water’s plan falls significantly short of our view of cost efficiency. It is more than 20% above our view of efficient and justified costs, even though its retail costs are efficient. It falls significantly short on long-term resilience, where the company

does not provide enough evidence across a number of areas. It does not demonstrate the use of a systems based approach; the resilience of its wastewater business; or that it has considered all relevant factors associated with maintaining long-term financial resilience. The plan also falls significantly short on accounting for past delivery, where we have concerns about the ability of the company to deliver the improved performance in relation to outcomes that it proposes to deliver for customers.

It falls short in other areas of the plan, including:

- **delivering outcomes** - we have concerns about the level of financial incentives on performance commitments, which include a number of incentive rates that are significantly different to the rates proposed by other companies, and performance commitments which are not sufficiently stretching. There is a lack of evidence to show how the results of customer engagement informed the company's approach to outcome delivery incentives.
- **engaging customers** - a lack of evidence to demonstrate the quality and depth of customer research.
- **targeted controls, markets and innovation** - while the company makes good use of catchment management, it provides limited rationale to explain why it rejected a number of potential direct procurement for customers (DPC) schemes;
- **aligning risk and return** – there is not enough evidence to support its choice of pay as you go (PAYG) and regulatory capital value (RCV) run-off rates and to support its proposed target credit rating;
- **confidence and assurance** - its Board does not provide a number of the requested Board assurance statements in full and there is insufficient detail on executive pay and dividend policies. The company's track record of producing high quality data falls significantly short of high quality.

Given the extent to which the plan falls significantly short of high quality and the material interventions required to protect customers, we have placed Southern Water in the significant scrutiny category. We commit to working closely with the company over the coming months to enable it to address the issues, to improve the overall quality of its plan and therefore the service it intends to provide to customers.

An overview of our assessment of the nine test areas and our grades for each test area are set out below. Our detailed assessment of the test areas is provided in 'Southern Water: Test area assessment' and 'Southern Water: Test question assessment' documents.

Table 1: Overall test area assessments

| Test Area | Our assessment |
|--|----------------|
| Engaging customers | C |
| Addressing affordability and vulnerability | B |
| Delivering outcomes for customers | C |
| Securing long-term resilience | D |
| Targeted controls, markets and innovation | C |
| Securing cost efficiency | D |
| Aligning risk and return | C |
| Accounting for past delivery | D |
| Securing confidence and assurance | C |

A = High quality, ambitious and innovative plan with evidence that overall is sufficient and convincing

B = High quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing

C = Concerns with the plan: Plan falls short of high quality and/or evidence is insufficient and/or unconvincing in some areas

D = Substantial concerns with the plan: Plan falls significantly short of required quality and/or little or no evidence, or no convincing evidence

Engaging customers

We are not convinced that the company engaged with a sufficient number of vulnerable and non-household customers in the development of its plan and we have not been provided with enough detail on its approach to customer research to have confidence in the findings. We have not seen convincing evidence to suggest that the plan fully reflected the results of customer engagement on acceptability and affordability of bill levels.

However, there are areas of the plan which are high quality. For example, the company demonstrates that it is learning from customer complaints data and that this data is informing the company's behaviour change programmes.

Addressing affordability and vulnerability

Overall the company performs well in this area. It proposes a sector-leading performance commitment to help customers who cannot pay their bills and proposes to reduce average real bills by 4.2% over 2025-2030.

However, the plan does not provide enough information on how the company will use data to help customers in vulnerable circumstances. The reach proposed for its Priority Services Register (PSR) membership is not sufficiently ambitious.

Delivering outcomes for customers

The plan contains good evidence of customer support for outcome delivery incentives for asset health and provides confidence about the protection of customers from higher than expected outperformance payments. However, the service levels the company has proposed for its performance commitments are not sufficiently stretching, particularly for its bespoke performance commitments.

We have concerns about the approach to setting outcome delivery incentive rates, where it does not clearly demonstrate the rates are rigorously based on customer evidence and in some cases are outliers relative to the rest of the sector. This includes the calculations for per capita consumption of water, leakage and maintaining bathing waters. We are not convinced that the package of outcome delivery incentives is balanced across the proposed performance commitments to address a broad range of issues across the company's activities.

Securing long-term resilience

The company's approach to assessing resilience falls significantly short of high quality. The plan focuses on resilience challenges in providing water services, but provides little evidence in relation to resilience of wastewater, which is where the company needs to improve. It also does not have an integrated and systems based approach to assessing its resilience.

Although the company has identified some risks to resilience, we are not convinced that the company fully understands them because there is a lack of detail on their impact and consequences.

The company has set out details of a plan to reduce financial gearing, by an equity injection to be funded from other group companies. However, the company has not provided sufficient evidence to demonstrate that it has considered what the long term resilience risks could be in relation to capital funded by other group companies.

Targeted controls, markets and innovation

The company's plan falls short of high quality in this test area. It is clear from the plan that innovative ideas are generated from all levels of the company, but it is not clear how the leadership facilitates an innovation culture.

While there is strong evidence of it working with third parties, including innovative partnerships with the Environment Agency and the National Farmers Union, to deliver its catchment strategies, the plan does not consider third party solutions sufficiently in other areas. For example, there is a lack of bioresources trading

options within the plan and a lack of evidence to justify the need for the Fawley desalination plant ahead of other potential regional water resources options.

The plan does not contain a strategy for managing the impacts of a water resources bilateral markets opening before 2025 and the revised draft Water Resources Management Plan does not fully address the issues that we raised in response to the consultation.

The plan does not contain enough evidence about the consideration of direct procurement for customers (DPC). Southern Water did not propose long-term risk sharing arrangements between customers and shareholders for its proposed Fawley desalination plant, even though significant costs are allocated to the water resources control.

Securing cost efficiency

We do not consider the company's 2020-2025 costs to be efficient when compared against our efficient baselines. At the company level its costs are around 21% above our view of efficient costs, even though its retail costs are efficient. Wholesale water and wastewater costs are both above our view on efficient costs.

Aligning risk and return

The company's plan is based on our 'early view' cost of capital and retail margins. However, there are two areas where the plan falls short. There is insufficient evidence:

- to support the choice of target credit rating for the notional structure, in the context of the investment programme and debt raising needs; and
- that PAYG and RCV run-off rates are appropriate and supported by customer preferences.

While the plan contains high quality evidence in its Return on Regulatory Equity (RoRE) analysis in the round, we have some specific concerns with the presentation of its analysis. For example, parts of the presentation are weighted towards underperformance and RoRE analysis is presented around an incorrect cost of equity.

Accounting for past delivery

Overall the plan falls significantly short in terms of accounting for past delivery, in particular on the evidence supporting its view of the deliverability of improved

performance on outcomes and major incidents. Despite this there are aspects of the plan which are high quality. The company has had good performance on costs, forecasting to underspend against its cost allowance for 2015-20. While the company is not meeting CCWater's 2020 household customer complaints target, it has significantly reduced the number of complaints, and provides evidence of the measures it will introduce to improve performance further.

On outcomes, the plan provides insufficient evidence that the company understands the drivers of its performance. The company provides some stretch in some of its performance commitments in its plan but provides insufficient evidence that it has appropriate measures in place to improve performance. We note that the company has stated it may need to restate some historical information, which suggests a risk around understanding of performance.

The company has had a number of serious pollution incidents and was required to provide an externally assured action plan following the 2018 freeze and thaw review. The plan provides insufficient evidence that it includes appropriate measures to improve performance in relation to major incidents.

Securing confidence and assurance

Overall, Southern Water's plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area. Although the company's Board provides assurance statements in the majority of requested areas, some of the statements do not contain supporting evidence and a number of the statements do not address all of the areas that they should.

The company does not provide enough evidence that it will meet our expectations in line with our putting the sector back in balance document. There is no commitment to future transparency of reporting on dividends or how it will explain of changes to customers and stakeholders. There is not enough evidence that the company's executive pay policy demonstrates a substantial link to exceptional delivery for customers. Additionally, the company falls significantly short of demonstrating that it has a track record of producing high quality data as we have identified serious concerns in two areas and minor concerns in two areas in our assessments within the company monitoring framework (excluding the elements related to the PR19 business plans).

2. Funding to facilitate the development of strategic water resources

We are providing funding to facilitate the development of strategic water resources options for the south and south-east of England to ensure that appropriate regional solutions can be taken forward in future investment plans. We expect companies to set out how they intend to work together to undertake more detailed feasibility and planning work.

£75 million of this funding will go to Southern Water.

3. Next steps and overall timeline

Actions for the company are set out in 'Southern Water: Actions summary table'. The next part of the process will be the draft determination, followed by the final determination, as set out in the table below.

| Date | Milestone |
|------------------|---|
| 1 April 2019 | Revised business plans submitted |
| 18 July 2019 | Draft determinations published |
| 30 August 2019 | Representations on draft determinations |
| 11 December 2019 | Final determinations published |
| 1 April 2020 | Price controls for 2020 – 2025 come into effect |

Appendices

The appendices below can find be found on our [website](#).

- Southern Water: Test area assessment
- Southern Water: Test question assessment
- Southern Water: Actions summary table
 - Southern Water: Delivering outcomes for customers detailed actions
 - Southern Water: Accounting for past delivery detailed actions
 - Southern Water: Securing confidence and assurance detailed actions
 - Southern Water: Direct procurement for customers detailed actions

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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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