Southern Water: Test area assessment

All company test area grades								
Engaging customers	Addressing affordability and vulnerability	Delivering outcomes for customers	Securing long-term resilience	Targeted controls markets and innovation	Securing cost efficiency	Aligning risk and return	Accounting for past delivery	Securing confidence and assurance
C	B	C	D	C	D	C	D	C

Southern Water - test area results				
Test area	**Overall test area grade**	**Overall test area summary assessment and rationale**	**TQ#**	**Test question grade**
Engaging customers	C	Overall the business plan falls short of high quality with insufficient evidence provided in relation to the areas set out below. Southern Water provides sufficient evidence of a high quality approach in the following areas: • Learning from customer complaints and other contact data is driving behaviour change programmes. • Its approach to adopting the four areas of action set out in the Tapped In report, including the use of reward schemes and publicity campaigns to effectively incentivise behavioural change. However, the business plan falls short of high quality with insufficient evidence, in the following areas: • Insufficient evidence that a broad range of vulnerable and business customers have been engaged with on a statistically robust basis. • Insufficient evidence that its primary customer valuation research and approach to deriving incremental benefits for use in outcome delivery incentives (ODIs) is robust. • The company provides evidence of using more innovative research methods such as mobile app-based ethnographic research, but insufficient evidence to support the rationale as to why these methods were chosen and how the results informed the company's business plan. • While there is sufficient evidence of the company engaging with customers regarding the acceptability and affordability of its business plan, the company does not appear to have fully reflected the results of this testing in its final plan and no evidence could found of the company explicitly testing long-term acceptability or affordability (for example, bill profiles for the post 2020-2025 period) with customers.	EC1	C
Addressing affordability and vulnerability	B	Overall Southern Water's business plan demonstrates high quality with convincing evidence that covers its approach to affordability and vulnerability as it: • proposes a high quality approach to helping customers who can't afford their bills, in particular it proposes a sector leading performance commitment (PC) to track the effect of the support it gives to customers; and • plans to reduce bills on average by 4.2% in AMP8. The company also undertook some customer research on long term investment preferences. The business plan falls short of high quality in two areas because the company: • is making a 3% bill decrease over the 2020-25 period but there was evidence of low customer support for the acceptability and affordability of bills; and • has provided insufficient evidence on its use of data to identify and help customers in vulnerable positions and its Priority Services Register reach is not sufficiently ambitious.	AV1 AV2 AV3 AV4	C B B C

Southern Water - test area results

Test area	Overall test area grade	Overall test area summary assessment and rationale	TQ#	Test question grade
Delivering outcomes for customers	C	Overall, across the delivering outcomes for customers test area, the evidence Southern Water provides to support its proposed PCs and ODIs in its plan falls short of high quality, and the evidence is insufficient or unconvincing in some areas. Overall the plan provides evidence of a high quality approach to its focus on service delivery within its overall risk/return package in the following areas: • ODIs for asset health PCs. • Approach to protecting customers from higher than expected outperformance payments. • It is the only company to provide convincing evidence for its enhanced ODI. However, the plan provides insufficient evidence that the company has appropriate, well-evidenced and stretching PCs and service levels for its bespoke PCs. Additionally, the evidence it provides to support its package of ODIs is insufficient and unconvincing. Key areas where the business plan falls short of high quality are: • The approach to triangulation, and the proposed rates include a number of industry outliers and the use of top-down / scaling factors in the ODI rate calculations for per capita consumption, leakage and maintaining bathing waters. • The company provides limited explanation of how its ODI package as a whole incentivises it to deliver its PCs, and its package is not sufficiently balanced across the PCs it proposes.	OC1	C
			OC2	C
			OC3	B
Securing long-term resilience	D	Overall, the plan falls significantly short of high quality and the company does not provide convincing evidence of securing long term resilience in certain areas. In terms of operational and corporate resilience, the company provides sufficient evidence that it has considered a wide range of options to improve resilience. The plan provides sufficient evidence that traditional infrastructure options are considered alongside, behavioural options, catchment options and softer engineering solutions. The plan provides sufficient evidence for some aspects of financial resilience assessment and risk management, but there is insufficient or unconvincing evidence in other areas. We consider that the company plan provides little evidence of a commitment to resilience in the round in the following areas: • There is insufficient evidence of an integrated and systems-based approach to resilience, where interdependencies or cascading impacts of one system to another should be considered. • There is little evidence that a clear and comprehensive baseline resilience maturity assessment, to convince us that the company has sufficient insight on its current corporate and operational resilience and that its plan will drive improvements in resilience. • The plan provides little detail that the overall resilience framework and resilience decision making builds on lessons learned in relation to operational and corporate resilience failings. • The company's plan focuses on resilience challenges in providing water services, but provides little evidence in most necessary areas in relation to resilience of its wastewater business where the company needs to improve from a challenging resilience position. • The company has identified some high-level risks to resilience but the plan provides little evidence on consequences and impacts of those risks needed to convince us that the company fully understands its risks. • The plan is not generally supported by well-defined and stretching common and bespoke PCs. • The plan presents insufficient evidence on the specific schemes being proposed as part of some of the transformational programmes, largely due to their early stages of development. • Whilst the company has considered the results of financial stress scenario modelling in terms of its key financial ratios, it is unclear the company has fully assessed the possible financial impacts of extant regulatory investigations. Although the company says that it plans to reduce its gearing from 80 to around 70% through a capital injection, there is insufficient evidence that it has considered the risk that capital raised by group companies above the level of the ring fence might place on the financial resilience of the Appointee.	LR1	D
			LR2	C
Targeted controls, markets and Innovation	C	Overall, despite some areas of high quality, Southern Water's plan falls short of high quality across the Targeted Controls, Markets and Innovation test area and evidence is insufficient and/or unconvincing in some areas.	CMI1	C
			CMI2	B

Southern Water - test area results				
Test area	**Overall test area grade**	**Overall test area summary assessment and rationale**	**TQ#**	**Test question grade**
		The company's plan has a bottom-up approach to promoting innovation within its business with convincing evidence on approaches to collaboration and participation, demonstrating that individuals can work together to generate innovative solutions. For RCV Allocation the evidence is complete. The company only convincingly demonstrates a commitment to using market led solutions in certain aspects of its plan. There is strong evidence of the use of markets including partnerships and catchment strategies across network plus for both water and wastewater. On water resources, however, despite a good level of engagement with demand side solutions, the plan lacks clarity on how regional solutions could displace the need for company solutions, to address a large water deficit in the short term. No strategy for bilateral markets is included in the plan and significant issues identified by Ofwat with the company's draft WRMP are not addressed. The company shows limited ambition to utilise bio-resources markets, only proposing short term trades to provide capacity. There is less convincing evidence about how either its environment and space or its leadership and support help facilitate an innovation culture. The company has considered the relevance of DPC for its investment programme, however, while it identifies a large number of potential schemes, little evidence is provided to support this and limited rationale is provided as to why the majority of these schemes were rejected. The evidence for the five short listed schemes is similarly insufficient with no Value for Money assessment included within the business plan. It is also concerning that the company does not provide any Long-term risk sharing arrangements for its Fawley desalination plant, even though significant costs are allocated to water resources.	CMI3	D
			CMI4	C
			CMI5	B
			CMI6	C
			CMI7	D
Securing cost efficiency	D	Overall, Southern Water's plan falls significantly short of the required quality in this area. We do not consider the company's costs for the 2020-2025 period 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. The company's wholesale water costs are around 21% above our view of efficient costs. Its wholesale wastewater costs are around 26% above our view of efficient costs. The costs of both base and enhancement are less efficient than industry benchmarks. The company is less efficient than its peers in the areas of the wastewater WINEP programme where we have been able to benchmark company costs. The company proposes three cost adjustment claims, two of which receive a partial pass for quality of the claim, and the third a fail, which gives the company a B in this area.	CE1	D
			CE2	D
			CE3	A
			CE4	B
Aligning risk and return	C	Despite some aspects of Southern Water's plan which are high quality, shortcomings in other aspects mean that it overall falls short of providing convincing and high quality evidence to support its approach in the area of aligning risk and return. The following area of the plan is high quality: • It is based on our Final Methodology 'early view' cost of capital and retail margins. There are two main areas where the plan falls short of high quality. It does not provide sufficient and convincing evidence: • to support the choice of target credit rating for the notional structure (Baa2/ BBB+ Moody's/S&P), 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. In particular, there is insufficient evidence to detail the assumptions and inputs in deriving forecast economic costs and the economic life of its underlying assets. While the plan contains high quality in its RoRE analysis in the round, we have concerns that the overall range of risk outcomes is unconvincing when compared with other companies, that the company's presentation of likely totex outturns is weighted towards underperformance on a notional basis and the RoRE analysis is presented around an incorrect cost of equity.	RR1	B
			RR2	B
			RR3	C
			RR4	C

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<tr><td rowspan="2">Accounting for past delivery</td><td rowspan="2">D</td><td rowspan="2">Overall, Southern Water's business plan falls significantly short of the required quality in accounting for past delivery.

In the round we have substantial concerns with the evidence for deliverability for the 2020-25 plan, in particular in relation to outcomes and major incidents.

The plan is high quality for deliverability in the following areas.
• The company is forecasting to underspend against its cost allowance for 2015-20 for water and wastewater wholesale. The company does not have a large overall efficiency challenge for 2020-25, but does have a significant challenge on retail costs. The company has provided sufficient evidence that its plan includes appropriate measures to deliver the necessary reduction in retail costs, so we do not have concerns with the evidence for deliverability of the planned costs.
• The company is not is not yet meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at stage one. However, it has significantly reduced the number of complaints whilst increasing the proportion resolved at stage one, and there is sufficient evidence of appropiate measures in the plan. We therefore do not have concerns with the evidence for deliverability for customer complaints performance in 2020-25.

The plan falls short of high quality for deliverability in the following areas.
• We have substantial concerns about the company's outcomes performance. It has delivered or is forecast to deliver 73% of PCs with financial ODIs in 2015-20, but it provides insufficient and unconvincing evidence that it understands drivers of its outcomes performance. We note that the company has stated it may need to restate some historical information, which suggests a poor understanding of performance. The company proposes improvement in performance in some of its PCs in its business plan but provides insufficient evidence that it the plan includes appropriate measures to improve performance. We therefore have substantial concerns with the evidence for deliverability of outcomes.
• The company has had four prosecutions by the Environment Agency and/or the Drinking Water Inspectorate and was required to provide an externally assured action plan following the 2018 freeze and thaw. The company provides insufficient evidence that the plan includes appropriate measures to improve performance in relation to incidents and so we have substantial concerns with the evidence for deliverability of improved performance in relation to major incidents.

There is sufficient and convincing evidence for six out of eight PR14 reconciliation areas and insufficient evidence for ODIs and totex. There is only a marginal difference (-0.7% of 2019-20 revenue) between expected and proposed reconciliations. In the round, the sufficient and convincing evidence for the PR14 reconciliations is not sufficient to raise the accounting for past delivery test area score.</td><td>PD1</td><td>B</td></tr>
<tr><td>PD2</td><td>D</td></tr>
<tr><td rowspan="2">Securing confidence and assurance</td><td rowspan="2">C</td><td rowspan="2">Overall, Southern Water's business plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area.

The company's business plan provides some evidence of high quality:

The company's Board provides a compliant statement of assurance with sufficient supporting evidence to demonstrate that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term.

The company's Board also provides a compliant statement of assurance with sufficient supporting evidence to demonstrate that the business plan will deliver – and that the Board will monitor delivery of – its outcomes.

The company's business plan provides sufficient and convincing evidence that overall, its business plan tables and the assurance and commentary provided are consistent, accurate and assured.</td><td>CA1</td><td>C</td></tr>
<tr><td>CA2</td><td>B</td></tr>
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<tr><td rowspan="4"></td><td rowspan="4"></td><td rowspan="4">The plan falls short of high quality in the following areas:

Although the company’s Board provides a majority of the requested assurance statements to demonstrate that all the elements of its business plan add up to a plan that is high quality and deliverable, an insufficient number have supporting evidence of the Board’s assurance process and a number of statements are partially compliant.

On providing evidence of a fair balance between customers and investors:
• The company forecasts gearing to not exceed 70% and states that, for years where gearing exceeds 70%, it will apply our gearing benefit sharing mechanism.
• The company also proposes a base dividend yield less than 5%.
• On executive pay, the company demonstrates insufficient evidence of its intention to meet the expectations set out in the ‘Putting the sector in balance’ position statement. There is insufficient evidence of how the targets will be stretching and aligned with delivery to customers. Also, there is no reference to the policy for 2020-25 and how it will be rigorously applied and monitored or evidence as to how changes will be signalled to customers.
• On dividend policy, there is insufficient evidence of the company’s intention to meet the expectations set out in the ‘Putting the sector in balance’ position statement. There is no clear Board commitment to publish detail on dividend policies annually and to signal changes to stakeholders. Also there is insufficient evidence of how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends.
• The company is highly geared but its Board provides only a partially-compliant assurance statement that its plan will enable customers’ trust and confidence through high levels of transparency and engagement on corporate and financial structures.
• Additionally, there is insufficient evidence that the company has been transparent with its customers about its corporate and financial structures and how they relate to its long-term resilience.
• The company does not put forward proposals for a bespoke voluntary benefit sharing mechanism but does propose contributions to social tariffs and its hardship fund which we assess could have a value of up to £2.5m per year. The company’s business plan tables indicate that these contributions contain some costs which are funded by customers. In the round, we consider that the company’s proposals fall short of high quality in terms of voluntary sharing, when considering its size. However, this does not influence our overall assessment for this test question in this instance.

The plan falls significantly short of high quality in demonstrating a track record of high quality data. In our assessment of the company in the 2018 Company Monitoring Framework (not including the elements related to the PR19 business plans) while the company meets expectations in 6 areas, it has minor concerns in 2 areas and has serious concerns in 2 areas.</td><td>CA3</td><td>C</td></tr>
<tr><td>CA4</td><td>B</td></tr>
<tr><td>CA5</td><td>D</td></tr>
<tr><td>CA6</td><td>B</td></tr>
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