

July 2019

Trust in water

# PR19 draft determinations

**Southern Water – Securing cost efficiency  
actions and interventions**

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## PR19 Draft Determinations: Southern Water – Securing cost efficiency actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix 'SRN' denotes the company Southern Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Actions whose numbers are preceded with an 'A' denote required actions and actions whose numbers are preceded with a 'B' denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix 'SRN' denotes the company Southern Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Southern Water draft determination, please see the [draft determinations webpage](#).

**Table 1: Southern Water's response to required actions and interventions for draft determinations**

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
Securing cost efficiency	SRN.CE.A1	Required	We provide our view of efficient costs for the company along with our reasoning. We expect it to address areas of inefficiency, or lack of evidence, in the revised business plan. Where appropriate, we expect it to withdraw investment proposals if either: the need for investment is not compelling; or there is no need for a cost adjustment claim beyond our existing cost baseline.	1 April 2019	Southern Water requests expenditure levels significantly higher than it has incurred historically, albeit the currently requested levels are substantially lower than in its September 2018 plan.  The company withdraws one of its cost adjustment claims that we rejected at initial assessment of plans and retains two claims for bathing waters and Thanet groundwater protection.  Southern Water accepts a number of our efficiency challenges from the initial assessment of business plans relating to the significant allowance	Intervention required.  There remains a significant gap in wholesale base costs, where we are proposing a significant reduction of 5% compared to Southern Water's business plan proposal which is in line with the company's historical base expenditure.  Based upon the evidence the company submits, we make a significant allowance for both local solutions delivering benefits in the 2020-25 period and beyond 2025, and for the	We provide our view of efficient costs for the company along with our reasoning.  We expect the company to continue to address areas of inefficiency and lack of evidence.  Given the presented scale and timing of supply-demand balance deficits we expect the company to deliver any solutions both efficiently and timely

					to maintain long-term resilience to drought. Across the business plan the company accepts some of our cost challenge and has reduced costs by approximately 11% across all areas. The gap is now 8%, which is lower than most of the slow track/significant scrutiny companies.	development of strategic regional water resource solutions.	to meet these challenges.
SRN.CE.A2	Required	There is significant investment proposed in the delivery of internal interconnections and long-term supply-demand benefits (benefits delivered after 2024-25) and therefore the company is required to propose an outcome delivery incentive in order to ensure customer protection for efficient delivery. The company should provide evidence to justify the level of the performance commitment and the outcome delivery incentive rates proposed, in line with our Final Methodology. We expect to receive evidence of customer support for outperformance payments, where proposed, and that the incentive rates proposed are reflective of customer valuations.	1 April 2019	The submission includes a bespoke performance commitment, 'IAP_TA11_CE_Long Term Supply Demand Schemes ODI SRN_CE_A2'. The company proposes underperformance payments for delay in forecast project delivery dates and if substantive progress is not made in the period 2020-25. The company basis the incentive rates upon the return and run-off rates of the total 2020-25 spend of the project and the percentage of benefit delivered by 31st March 2027.	Intervention required We assess the information the company provides in its submission and intervene to modify the bespoke performance commitment, 'PR19SRN_WN12 Long term supply demand schemes to ensure customer protection' ('Southern Water - Outcomes performance commitment appendix').	Company to provide response to the revised performance commitment in its representation to the draft determination	
SRN.CE.A3	Required	Strategic regional solution development - We have identified from the plans that at least one strategic supply solution is required over the next 5-15 years to secure drought resilience in the south-east. The strategic regional solution development allocation is to allow the delivery of consistent and transparent investigations, planning and development of strategic options with the overall aim of optimum solutions being construction ready by 2025. The company's allocation is made on the basis of having clear deliverables and customer protection for the gated delivery of the development of Abingdon reservoir, a regional transfer from Thames Water, and Fawley desalination/local transfer schemes. The following actions are required to ensure the efficient delivery of this development programme. <ul style="list-style-type: none"> <li>• In conjunction with the other companies involved, jointly propose methods for collaborative working including setting up the joint working group for individual schemes, and how consistent assumptions and decisions will be made within these groups and between them.</li> <li>• Provide more detail on the gated process, the deliverables, timings and expenditure allocations at each gate</li> <li>• Propose outcome delivery incentive-type mechanisms to allow allocated funding to be recovered by customers in the event of the scheme not progressing</li> </ul>	1 April 2019	The company's strategic regional water resources submission includes a joint statement by six companies via Water Resources South East. This joint statement considers: the principles for joint working; timing of the gateways; increased detail of the work between the proposed gates; the principles of a change protocol to manage changes to schemes in the proposal and to change the current list of schemes when required; development of the principles of an outcome delivery incentive type mechanism to allow funding to be recovered by customers in the event of the scheme not progressing and for the non-delivery or late delivery of outputs.  In an addendum to the joint statement, submitted on 3 May 2019, the same companies specify key principles for a 'hybrid approach' outcome delivery incentive mechanism.  Southern Water also submitted scheme specific reports on 3 May for Fawley desalination, River Itchen	Intervention required. We have assessed the revised submissions (both joint and company specific) to intervene for the draft determinations. This includes updates to cost allowances for this development programme, gate delivery updates and the end of period reconciliation mechanism to protect customers. The detailed assessment and rationale is provided in the 'Strategic regional water resource solutions appendix'.	Company to present joint solutions consistently with solution partners and clearly set out the costs related to strategic regional water resource solutions in its representation to the draft determination.  Southern Water to provide clearly evidenced detail of the deficit the solutions are required to address, accounting for the significant draft determination allowance for other projects delivering supply- demand benefits.	

			<p>through each gate and for the non-delivery or late delivery of outputs.</p> <p>Intervention updates and clarifications:</p> <p>We sent clarification of our expectations for information relating to this action that we expected information submitted on 1 April to be as accurate and complete as possible, but accepted that given the timescales and joint working implications this may be in draft form. However, we wanted clarity on the costs relating to strategic regional water resource solutions and the solutions this relates to be summarised by 12 April, with the final information covering the action by 3 May.</p>		<p>reuse and Thames Water to Southern Water transfer.</p> <p>Southern Water additionally has responded to query SRN-DD-CMI-002 regarding how planning deficits vary with drought severity across its region. There was not time to fully include this information within the draft determination analysis but we will consider it further in order to understand the deficit 'gap' that these regional solutions would be required to meet for Southern Water.</p>		
	SRN.CE.A4	Required	<p>We note the company's proposal that for Bathing and Shellfish requirements any changes to the environmental requirements are treated on a bespoke basis (even though there are no company-driven Amber schemes in WINEP3). The company should confirm our assumption that this means that any changes would be dealt with in the same way as Chiddingfold and Buriton. The company should clarify its proposals for Amber schemes in WINEP3 with the following drivers: INNS_ND, NERC_INV1, SSSI_INV and WFD_IMP_WRFflow. The company should provide the total cost included for Amber WINEP requirements in its business plan and the breakdown of this cost between the relevant lines in tables WS2 and WWS2 (capex and opex).</p>	1 April 2019	<p>The company provides further clarification regarding the change mechanisms proposed for the environmental programme and includes proposals both for Amber schemes and for obligations where, in the absence of scheme-specific detail in WINEP, the company has needed to make assumptions about the specific enhancements required to be delivered. Southern Water has reviewed the full suite of change mechanisms in response to the initial assessment of plans. The company provides costs for the components of its Amber programme and clarifies the lines in tables WS2 and WWS2 to which these costs are allocated.</p>	<p>Intervention required.</p> <p>We are changing some aspects of the company's adjustments to reflect differences between the scale of assumed and eventual environmental improvement programmes to reflect our view of efficient costs.</p>	<p>In 'Southern Water - Securing cost efficiency actions and interventions' we provide our view of the unit rates to be used in the cost adjustment mechanism...</p>
	SRN.CE.A5	Required	<p>There may be significant impacts in terms of investment or type of investment as a result of the metaldehyde ban. The company should investigate and agree with the DWI the scale and timing of any potential changes compared to its submitted plans. Significant changes and uncertainty may require an outcome delivery incentive to protect customers in the instance of expenditure not being required. Should the company propose a performance commitment and outcome delivery incentive, the company should provide evidence to justify the level of the performance commitment and the outcome delivery incentive rates proposed, in line with our Final Methodology. We expect to receive evidence of customer support for outperformance payments, where proposed, and that the incentive rates proposed are reflective of customer valuations.</p>	1 April 2019	<p>The company states that its current undertakings are not constrained to metaldehyde and include a range of pesticides. Therefore, Southern Water considers it remains necessary to undertake catchment management activities in six catchments in the 2020-25 period and costs in this area of its plan will not change. The company states it has confirmed this approach with the DWI.</p>	<p>No intervention required for draft determination but further action needed by the company.</p> <p>We assess the information the company provides and recognise the necessity of continuing catchment management activities in these areas. However, we require the company to confirm that it includes no metaldehyde specific activity costs that are no longer necessary, such as product substitution, within its requested allowance.</p>	<p>Company to provide evidence to confirm DWI agreement with its submitted plans/revised undertakings and that no metaldehyde specific costs are included in the requested allowance.</p>

	Advised actions	Advised	No advised actions	N/A			
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**Table 2: Further interventions for draft determinations**

Intervention reference	Our assessment and rationale	Interventions
<p>We explain our approach to cost assessment, including the allowances we set for each control, assumption on revenue recovery from grants and contributions, opex-capex split and totex profiling, in 'Securing cost efficiency technical appendix'. We set out other company specific interventions, and the allowances we set for each control, in section 3 of the company's draft determination summary and its cost efficiency appendix.</p>		

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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July 2019

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