



# **Ofwat: Draft 2020-25 price control determination for Southern Water**

**CCWATER RESPONSE**

**AUGUST 2019**

## Introduction

1. The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's 2020-2025 draft price control determination for Southern Water.

## Section A - Executive Summary

### Customer Acceptability

2. It is vital that customers find the outcome of the price review acceptable, to improve perceptions of fairness and value for money, and to help improve the legitimacy of the industry in customers' eyes. CCWater's research into the acceptability of the draft determination found that 83% of the Southern Water customers surveyed thought the proposals were acceptable (uninformed acceptability based on bill change from 2020 - 2025), indicating a high level of acceptability from customers. Further details on our research can be found below.

### What we support

3. We are supportive of the following aspects of the draft determination:
  - The reduction in the Weighted Average Cost of Capital to 2.19%<sup>1</sup>, which is within the recommended range of a CCWater commissioned independent study of water company financing, market evidence and financing assumptions made in other regulated sectors. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to Final Determinations of price controls.
  - Funding for the delivery and evaluation of resilience and water resource schemes to help address the water resources issues in the South East
  - The acceptance of the company's Per Capita Consumption (PCC) target

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<sup>1</sup> Real (RPI) appointee level

- Bespoke Performance Commitments (PCs) for affordability and vulnerability and the initiatives the company is introducing in these areas.

### What we have concerns with

4. We are concerned about the following issues:
  - The lack of weighting given to complaint performance within C-MeX, which could see companies achieving rewards for static or declining performance.
  - The potential impact of Outcome Delivery Incentives (ODIs) on bills, particularly where there is not strong customer support for the principle.
  - The risk that investment schemes that are important to customers are deferred or removed in order to reduce costs.

## Section B - Our detailed comments

### Customer acceptability

5. It is vital that customers find the outcome of the price review acceptable, to improve perceptions of fairness and value for money, and to help improve the legitimacy of the industry in customers' eyes. Our research found that a high proportion of Southern Water's customers think that the draft determination proposals are acceptable. 83%<sup>2</sup> of both uninformed and informed customers said the plan was either "acceptable" or "very acceptable." Given this high level of acceptability for the price and service levels, it is important that Ofwat and Southern Water ensure that the final determination continues to deliver a package that allows customers' priorities to be delivered at a price that they accept.
6. We give a higher weight to uninformed acceptability scores than informed, because this is a better reflection of how the vast majority of customers will react to a price determination, as the average customer does not receive very much information about the price review outcome.
7. 70% of customers found the potential impact of Outcome Delivery Incentives (ODIs) on their bills over the period to be acceptable. This is a notable decrease compared with the levels of acceptability achieved by the "base" plan. This highlights the

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<sup>2</sup> Unweighted topline figures as of 23 August 2019. Figures may change slightly in the final report.

potential for there to be a customer backlash against the impact of ODI outperformance payments on bills if this is fully realised.

8. These top-line findings give an indication of customers' feelings about the draft determination. The full report, which will explore the reasons behind these answers in more detail, will be published on our website. This will help Ofwat to understand the reasons why customers found the draft determination acceptable or unacceptable: <https://www.ccwater.org.uk/research/category/price-reviews/>

### Bill profile and cost efficiency

9. The draft determination would see bills reduced by 6% after inflation<sup>3</sup> over the period 2020-25. Ofwat's reported figure (a 14% reduction) does not include inflation and the impact of ODIs, so we expect the company and Ofwat to make this clear to customers when explaining bill impacts at final determination and beyond. The figure also does not include any penalty payments arising from the recent Ofwat investigation. As a result, bills could be reduced further if Ofwat's provisional findings in the penalty notice are confirmed.
10. In real terms, Southern Water customers will see bills decrease in 2020-21, and then remain stable for the remainder of the price control period. As Southern Water's research showed customers supported a smooth bill profile, the initial reduction followed by a smooth profile is acceptable to customers (as shown by the level of customers who found the year-on-year combined bills proposed in the draft determination to be acceptable in our research: 83% uninformed, 82% informed)

### Weighted Average Cost of Capital WACC:

11. An independent study commissioned by CCWater<sup>[1]</sup> has recommended a range for the Weighted Average Cost of Capital (WACC) between 1.7% to 2.3%<sup>[2]</sup>, based on an analysis of water company financing, market evidence and financing assumptions in

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<sup>3</sup> Based on an assumption of 2%pa CPI-H

<sup>[1]</sup> Economic Consulting Associates (ECA) recommendations for the Cost of Capital 2020-25 (April 2019) – this is an updated recommendation for the cost of capital, following on from an ECA recommendation originally published in December 2017. The April 2019 update takes into account new evidence that has emerged in 2018 and 2019: <https://www.ccwater.org.uk/research/update-to-eca-recommendations-for-the-cost-of-capital-2020-2025/>

<sup>[2]</sup> Real (RPI) WACC appointee level

other regulated sectors. We note that for the slow track and significant scrutiny draft determinations Ofwat has used a WACC of 2.19%. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to final determinations of price limits.

#### Cost efficiency

12. It is important for customers that Ofwat makes sure that companies deliver service improvements efficiently. While the companies can opt to appeal the final determination with the Competition and Markets Authority (CMA), customers do not have the option to appeal if their expectations are not met or the price determination 'package' is unacceptable to them. However, the efficiency challenge to companies should not put in jeopardy the delivery of any well-evidenced PCs, service improvements and/or investment that customers value.
13. Ofwat should ensure that its approach to assessing the totex required is valid and ensures there is an efficient delivery of services and improvements. It is the companies' responsibility to ensure that their commitments to customers can be and are delivered. It would not be in customers' interests for companies to defer or reduce their commitments to customers in response to the regulatory cost efficiency challenge.

#### Pay as you go ratio (PAYG)

14. The PAYG ratio should reflect the balance of short and long term cost recovery relative to the companies' balance of operational activity and longer term capital investment. However, the ratio can be used to improve the financeability of the determination or to help 'smooth' the short and long term bill profiles for customers.
15. When costs are reallocated from one category to another (e.g. from 'base' to 'enhancement'), this can have a knock-on effect on the PAYG ratio as capital costs are typically recovered in the longer term. Ofwat should be clear in the Final Determination for Southern Water where changes in the cost assessments have led to a revised PAYG and that the ratio strikes the appropriate balance of cost recovery from current and future customers.

## Safe, reliable services: maintenance and long-term investment

16. In Ofwat's Initial Assessment of Plans (IAP) and the Draft Determination, Southern Water is asked to provide an action plan by 22<sup>nd</sup> August to '*develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans, showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework*'.
17. We support this action and look forward to seeing the company's response to this challenge and working with them as they develop this framework.
18. We would like to see how Southern Water's PCs and investment allowed for in the final determination will address current and future resilience risks as a result of this action plan. We would also like to hear from Ofwat about the interventions it would make if Southern Water's action plan is viewed as sub-standard.
19. Resilience can be affected by factors that may be uncertain or unforeseen now but may affect the company's ability to deliver its services reliably and securely in the future. Therefore, we wish to see Southern Water showing flexibility to adapt to changes to current and future risks, and demonstrating to their customers and stakeholders that they have done so.

### General comments

20. Ofwat has also identified that Southern Water has a number of (resilience) schemes that would bring greater benefit to customers if delivered through a 'direct procurement' process. These projects include: Fawley desalination, Peacehaven indirect potable re-use and Slowhill Copse industrial reuse.
21. From the company's key PCs related to water supply resilience, we can see that Southern Water is following a 'twin track' approach of reducing the amount of water it takes from the environment (by reducing leakage and personal water use) and developing new resources, such as desalination, re-use and developing the joint reservoir (Havant Thicket) with Portsmouth Water. We note there is an enhancement

allowance of £175 million to improve the supply/demand balance, which should help to deliver this approach.

22. All of these are positive steps towards increasing the resilience of future water supplies in the area. We support the twin track approach, particularly as Southern Water currently has a lack of resilience in its western area where it needs to find new alternative supplies to meet future demand and ease pressure on the rivers in Hampshire. We are also supportive of looking at different delivery models, as ultimately we want to ensure that the options chosen deliver best value for Southern Water's customers.

### Wastewater Services

23. One of the criticisms of Southern Water's Business Plan was that it was focused on the resilience of its water services and was lacking on resilience in wastewater services.
24. Furthermore, the Ofwat penalty notice identified a number of failings in the operation of the company's wastewater services. Some of the measures being put in place to address these include stringent underperformance payments on wastewater treatment works compliance and pollution incidents to protect customers from future service failures. We support the measures contained in the Ofwat penalty notice and will wait for the outcome of the Environment Agency's investigations to understand any future repercussions these may have.

### Strategic Water Resource Options

25. We are supportive of initiatives to improve the security of water resources, including the development of new water resources and water supply transfers, as long as they deliver the best overall value. We agree that water companies should work together on strategic solutions in the context of the National Water Resources planning framework. Ofwat is allowing the company £82 million to evaluate, in partnership with others, potential strategic regional water resource solutions. This includes the company progressing both Fawley desalination and River Itchen reuse solutions. This is to be welcomed, given that the company must find alternative supplies for its western region. We are also pleased to note that the company is being encouraged to consider direct procurement options, which may help to keep costs down.

26. There is also support from Ofwat for Havant Thicket Reservoir via a separate 10-year price control allowing £120 million for Portsmouth Water. We have concerns about how the scheme will be funded as it is important that the financial arrangements do not introduce any cross-subsidy between the two companies' customers. We would also welcome greater clarity over the planned contractual arrangements and how the risks of this scheme will be shared between the two participating companies - Southern Water and Portsmouth Water.
27. More needs to be done to give clarity on how water transfer schemes will be funded, remunerated and how such arrangements will be regulated in a way that benefits all customers.
28. Customers from 'exporting' regions should not be expected to bear any undue costs associated with the planning or implementation arrangements required to facilitate a future transfer of water from their region to others. However, we are reassured that there will be a mechanism that allows money allocated to this work to be returned to customers if a scheme does not proceed.

#### **Outcomes - Performance Commitments and Outcome Delivery Incentives**

29. Overall we consider that Southern Water's PCs are stretching, reflective of customer priorities and were developed based on extensive evidence of customers' views collected during the development of its business plan. However, we believe the evidence collected by the company also confirmed that customers have concerns about the principle of companies receiving financial rewards for delivering services, and the impact this may have on bills.

#### **Leakage**

30. Although the company is following the industry's commitment to reduce leakage by 15% (against the 2020 level), we are concerned about how stretching this may be, considering that the company is likely to miss its leakage target for the current AMP (2015-2020). It is important that the company delivers on its targets in this area, which is a high priority for customers.



### Per capita consumption (PCC)

31. We support the company's commitment to continue to engage with its customers to reduce their personal water use. At present, Southern Water is one of the best performers in this area amongst water companies in England and Wales. Looking towards the future, the Target 100 initiative will be challenging but could bring great benefit to a company in an area where water resources are already stretched.
32. However, and as mentioned above, we remain concerned about the impact a negative performance on leakage could have in this area - customers are willing to do their part (reduce water use) as long as the company does theirs (i.e. reducing leakage, which is seen as a waste).

### Customer Experience Measure (C-MeX)

33. We welcome the clarity on the details of the shadow reporting of the C-MeX - which will inform its final design - and will monitor how this progresses. We remain concerned that there may be insufficient weighting given to a company's complaints performance, so companies may not face sufficient pressure to improve their complaint handling performance. They may also be able to achieve a financial reward even where their complaint performance is static or declining.
34. Until recently, Southern Water has had longstanding problems with its complaints performance compared to other companies. More recently, it has seen improvements in its complaint levels. We are aware that significant reorganisation of its customer service operations is underway and would be concerned if the new measure took attention away from complaint handling and resolution.

### Outcome Delivery Incentives (ODIs):

35. The use of ODIs has a risk of a negative customer reaction, if customers do not support the use of these financial incentives, and outperformance payments lead to higher than expected bill increases. Therefore, companies must demonstrate clear customer support for both the principle and the range of ODI payments before they are included in price determinations. We do not believe Southern Water's research did this as it failed to test the principle of using ODIs with customers.

36. CCWater's research to test the customer acceptability reduced from 83% to 70% once customers were shown more details about the potential bill impact of these incentives. While this reflects the top-line research results (the full analysis will follow), it may indicate that fewer customers accept the ODI package when they see how this may affect their bills.
37. Southern Water has accepted Ofwat's 'standard' sharing mechanism where 50% of outperformance payments that exceed 3% of return on regulatory equity (RoRE) in any year is shared with customers through additional investment in the following year. As part of its original submissions, Southern Water felt it had provided clear evidence of the overall level of bill protection provided through a cap and a collar. However, Ofwat is imposing its customer protection measures to make sure customers are adequately protected, while maintaining appropriate levels of incentives for companies to deliver on customers' preference. We welcome this approach.

### **Affordability & Vulnerability**

#### Affordability:

38. We are pleased to see progress being made to support customers who are struggling to pay. However, we believe companies still need to do more to resolve the affordability problem. Across the industry, there will still be more than one million customers who are in need of assistance but not receiving it, even after the improvements companies are making.
39. Our Water Matters research (2018) found that 70% of Southern Water customers considered their charges to be affordable. CCWater's research into Southern Water's Draft Determination found that 55% of customers thought current charges were affordable but that this increased to 72% when they were shown the effect the draft determination proposals would have on their bills. This indicates that there will still be a significant proportion of customers who will struggle to afford their bills and will require additional support.
40. In addition to the bill reduction for Southern Water's customers between 2020 and 2025, the company has committed to:

- increase the capacity of its affordability schemes and tariffs to support a total 155,000 customers per year by 2024-25,
  - extend the types of support available through the PSR from 29 to 53
  - introduce payment breaks to assist customers experiencing transient vulnerability and are (temporarily) unable to pay their bills.
41. We are very supportive of the commitments Southern Water is making in this area. We also welcome the work the company has been doing with other water companies on aligning the social tariff eligibility criteria. This work will make social tariffs more accessible to customers and support agencies and will also make it easier for water companies to manage the schemes. It shows there is a commitment to help those customers who are in need.

### Vulnerability

42. We welcome the intervention Ofwat has made to amend the PC on the Priority Services Register (PSR). As a result, Southern Water should include a PC to increase its PSR reach to assist 7% of its customer base (households) by 2024-25 and commits to checking 90% of its PSR data every two years. It appears that, although this is a significant increase from the company's original proposal (0.4% in 2019-20 to 1.1% households in 2024-25), this can be accommodated within Ofwat's current projections of efficient costs.
43. We look forward to tracking the company's progress in relation to its three bespoke performance commitments on affordability and vulnerability. These include improving effectiveness of financial support, customer satisfaction with its vulnerability support and customer views of value for money.
44. While we welcome the new common PC to measure the PSR, we are concerned that a PC target to increase the number of customers on priority services registers can drive a focus on numbers instead of the quality of assistance provided. We want to ensure that help is meaningful for customers.
45. We would like to see companies go further than focusing solely on PSRs to ensure that all consumers receive the support they may need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability such as

during a water supply interruption). It is important that consumers receive support when they need it and that they are satisfied with the assistance provided. It is crucial that companies raise awareness of the support available so that consumers know what help they can access.

46. In this context, we support Southern Water introducing measures that will help people in ‘transient vulnerability’ who may be struggling to pay their bills. While this is a step in the right direction, we feel that there should be more focus on identifying and delivering the support that consumers in transient circumstances need.
47. We also feel that consumers receiving support (and/or their representatives) are in the best position to advise on whether the help is meaningful and there should be more focus on establishing and measuring this. To support this, a measure of consumer satisfaction with services provided would be of benefit.
48. We expect retailers and wholesalers to collaborate to identify any non-household consumers who need additional support. We will monitor what help consumers are signing up for. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
49. Following the Initial Assessment of Plans (IAPs), we challenged Ofwat’s proposed vulnerability PC requiring companies to contact 90% of consumers on the PSR every two years. We felt more clarity was needed on what “contact” meant, e.g. does it involve interaction from both parties such as consumer and the company? In the Draft Determinations, Ofwat has provided reporting guidance on what “contact” means and has also split the data checking PC into two parts:
  - % of customers attempted to contact to check data = 90%
  - % of customers actually contacted to check data = 50%We support this as a sensible move.

### Other key company specific issues

#### Southern Water Fine:

50. In June 2019, Ofwat published its proposal to issue Southern Water with a financial penalty amounting to £37.7 million (reduced to £3 million) for significant breaches of

its licence conditions and its statutory duties. This reduction is on the basis that Southern Water has undertaken to pay customers £123 million over the next five years. Some of this is a payment of price review underperformance penalties which the company avoided paying in the period 2010 to 2017, and the rest is a payment to customers for the failures set out in the notice, paid in lieu of a penalty.

51. The failings relate to the management, operation and performance of Southern Water's wastewater treatment works. The environmental consequences of the poor management and performance of the wastewater treatment works are yet to be fully established. We must await the outcome of the Environment Agency's investigation to understand the full extent of the impact on the environment.
52. In addition to the environmental damage, the company's actions have further consequences for customers. They have effectively paid more than they should have for their wastewater service and, perhaps more importantly, have been misled about the company's environmental performance over a number of years. The current Board and senior management will not easily restore the resulting loss of trust.
53. As stated in Southern Water's draft determination, the impacts of the fine have not been considered at this stage. As a result, the bills customers will pay in the period 2020-25 could be lower than set out in the draft determination.
54. We look forward to hearing from the company on the steps it is taking to address its past failures, and to reassure its customers that it will not happen again. Southern Water will need to work hard to restore customers' and stakeholders' trust.

## Water Industry National Environment Programme (WINEP) & Statutory Schemes:

55. We are concerned that some ‘amber’ schemes in the Water Industry National Environment Programme (WINEP) for Southern Water have not been included in this draft determination. We understand that this means customers will not pay initially for something that may not be necessary but if they all go ahead, as the Environment Agency (EA) expects, this will impact customers’ bills in 2025-30. We continue to urge Ofwat and the EA to explore ways in which customer views can be taken into account when considering the cost effectiveness of investments to improve the environment.
56. This is especially important as the company suffered a small number of more serious pollution incidents during the year (2018-19)<sup>4</sup>. It is reassuring that Southern Water is working closely with the EA on this matter, not only to learn lessons but also to provide the adequate investment to improve the company’s resilience. Having said that, it appears that pollution reduction is one of the areas where Ofwat has imposed a cost challenge in its draft determination.
57. In the Draft Determination, Ofwat is giving an allowance for schemes with ‘green’ or ‘amber’ status. There are plans for a cost adjustment mechanism to change the allowance once the uncertainty has been resolved.
58. It is encouraging to see that £547 million has been allocated to improve the environment by delivering the WINEP requirements. However, we have concerns that some of the solutions may have to be used to address short term issues rather than looking at potentially more expensive but ultimately more sustainable, longer term solutions that would also have a positive impact on the environment. These include:
- Adding equipment to treatment processes rather than working at catchment level to address problems.
  - Being less proactive in extending the network to account for future (population) growth and development.

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<sup>4</sup> <https://www.southernwater.co.uk/the-news-room/the-media-centre/2019/july/our-environmental-performance>

- Improving resilience on the sewerage side could also be limited. This conflicts with Ofwat's view that Southern Water needs to improve on the resilience of its wastewater business.

### Population Growth

59. We note the differing sources of evidence of population growth forecasts used by Ofwat and companies. As this can be a significant driver of both costs and revenue, Ofwat needs to ensure that its final determination allowance for Southern Water reflects the most robust forecasts.

### **General Comments:**

#### Innovation

60. We understand that Ofwat is considering an additional revenue adjustment for the final determinations, to allow Southern Water additional costs to drive further innovation. We consider it essential that the industry should constantly be looking for new and better ways to think and operate. We welcome Southern Water finding innovative ways to effectively and efficiently address the challenges facing the sector and its customers, including climate change; aging assets; a growing population; and changing customer expectations.
61. Southern Water may develop innovative methods to delivering services that have a tangible positive impact on customers; for example, in areas such as service quality, affordability and vulnerability.
62. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case if companies are also challenged to be more efficient. A draft determination that places greater commitments on Southern Water to improve service delivery, protect the environment, and improve the resilience of their assets and operations should encourage innovative solutions without the need for a special revenue adjustment.

63. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

Developer Services Experience (D-MeX):

64. While we have welcomed the introduction of new measures designed to improve developer experience with companies, we have some questions about how this will operate:

- We note that the quantitative D-MeX score is based on a survey of transactions and that the water companies are in the process of operating a shadow year. At the end of the shadow year, will Ofwat review whether these metrics have incentivised good behaviour, as planned? If so, how will it ensure that companies are incentivised to perform as well as possible and not just ‘sufficiently’ well in order to meet the minimum requirement?
- The qualitative score is given by developer customers surveyed in the customer satisfaction survey. Self-lay operators and new appointees have a much smaller proportion of the market. How does the mechanism reflect the experience of self-lay operators and new appointees in this market?
- According to the outcomes PC appendix for each company, each company’s score will be calculated by multiplying the incentive rate with the annual developer services revenue. It seems to us, therefore, that if a company has higher charges, it could achieve higher rewards. Conversely, if a company collects less revenue because there is a more competitive market in its supply area, then it could be penalised. How does this mechanism ensure that the right behaviour is incentivised?

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