

November 2021

Final determination of Southern Water's in-period outcome delivery incentives for 2020-21

Ofwat

About this document

This document provides our final decision on adjustments to Southern Water's price controls for the company's performance for the 2020-21 Charging Year, under Part 3A of condition B of the company's licence (Performance Measure Adjustments, referred to in this document as 'in-period' determinations). The specific changes, and our reasons for these, are set out in this document and ['Sector overview: Final determinations of in-period outcome delivery incentives for 2020-21'](#).

We also publish models related to our final determinations on our [website](#).

Executive summary

This section sets out the results of our 2020-21 in-period outcome delivery incentive (ODI) assessment for Southern Water. ODIs are the financial or reputational consequences for companies of outperformance or underperformance against their performance commitments. Performance commitments are the pledges companies made to their customers and stakeholders at the 2019 price review (PR19) about service levels to make progress towards their outcomes.

'In-period' ODIs bring ODI payments closer in time to when customers experience a given level of performance. We do this through an annual reconciliation process between July and November following the relevant reporting year, in this case 2020-21. The results of our assessment for 2020-21 will affect Southern Water's customers' bills in the 2022-23 Charging Year.

For 2020-21 Southern Water reported net underperformance payments of £41.305m against its performance commitments with in-period outcome delivery incentives, excluding C-MeX and D-MeX. We assessed the company's performance against its performance commitments and, in October 2021, consulted on our [draft determinations](#) for companies' in-period ODIs for 2020-21.

Having considered the responses to our draft determination we are intervening on the following performance commitments:

- Water quality compliance (CRI, or the compliance risk index) - we are increasing the company's underperformance payment by £0.056m to align with the latest data from the Drinking Water Inspectorate.
- Leakage – we are deferring our determination of the value of the company's ODI payments due to uncertainty that the company's reported leakage is calculated in a way that is consistent with how the leakage targets were set.

- Per capita consumption (PCC) – in line with our decision following our per capita consumption consultation, we are deferring our determination of payments for performance against this performance commitment for the 2020-21 Charging Year.
- C-MeX and D-MeX – we are including a C-MeX underperformance payment of £4.906m and a D-MeX underperformance payment of £1.033m, based on assessment of 2020-21 company performance in our draft determinations.

Our final determination is that the amount of revenue the company can recover from its customers in 2022-23, as a result of its performance against its performance commitments with in-period ODIs in 2020-21, is reduced by £45.995. This figure includes C-MeX and D-MeX payments as well as bespoke adjustments but is before adjustments for inflation, tax and other relevant factors.

Further details regarding the responses we received, our final decisions and the adjustments that we have made are presented in sections 2 and 3, and ['Sector overview: Final determinations of in-period outcome delivery incentives for 2020-21'](#).

Contents

1. Introduction	4
1.1 Background	4
2. Results of our assessment	5
2.1 Reported performance	5
2.2 Key interventions	5
2.2.1 Water quality compliance risk indicator (CRI)	5
2.2.2 Leakage	5
2.2.3 Taxation	7
2.2.4 Environmental impact of pollutions	7
2.2.5 C-MeX and D-MeX	8
2.3 Payment deferrals and abatements	9
2.3.1 Per capita consumption	9
3. Impact of 2020-21 in-period ODI assessment on price controls	11
3.1 Our final determination	11

1. Introduction

1.1 Background

Southern Water's performance commitments for the 2020-25 period are set in [PR19 final determinations: Southern Water - Outcomes performance commitment appendix](#).¹ Most of the company's performance commitments have financial incentives which are paid 'in-period'. This brings ODI payments closer in time to when customers experience a given level of performance. The remaining incentives are end of period.

Southern Water reported its performance against these performance commitments in its annual performance report (APR) in July 2021. We considered this information and, where relevant, further information from companies' answers to our queries. In October 2021, we consulted on our draft determination for Southern Water's in-period ODIs for 2020-21. We have considered the responses we have received relating to our draft determination.

Our final determination sets out the adjustments to the company's price controls and will affect Southern Water's customers' bills from the 2022-23 Charging Year.

¹ We take account of performance commitments as set out in the PR19 definitions adjusted, if relevant, by the annex 2 process. Annex 2 of the company's performance commitment appendix provides for changes and corrections to be made to its performance commitment definitions during the 2020-25 period in certain circumstances. An overview of changes and corrections made to companies' performance commitment appendices can be found at [PR19 Outcomes performance commitments: changes and corrections](#).

2. Results of our assessment

2.1 Reported performance

Southern Water's reported performance for 2020-21 against its performance commitments with financial in-period ODIs is set out in table 3.1 below. The company's largest individual underperformance payment is £19.400m for its treatment works compliance performance commitment. The company's largest individual outperformance payment is £0.014m for its external sewer flooding performance commitment.

2.2 Key interventions

2.2.1 Water quality compliance risk indicator (CRI)

Our draft decision

In our draft determination we intervened to increase Southern Water's underperformance payment in relation to its water quality compliance (CRI) performance commitment to align with the latest Drinking Water Inspectorate (DWI) data, which was not available at the time that Southern Water submitted its data. Southern Water reported a CRI of 4.53 (which resulted in an underperformance payment of £1.589m). The latest DWI data shows that Southern Water's CRI was 4.62 (which resulted in an underperformance payment of £1.645m). Our intervention increased the company's underperformance payment for this performance commitment by £0.056m.

Stakeholders' responses

Southern Water stated that it agreed with the revision to the ODI underperformance payment for CRI, as it uses the latest Drinking Water Inspectorate (DWI) data, which was not available at the time it submitted its data.

Consideration of responses and final decision

Our final position remains unchanged from our draft proposals.

2.2.2 Leakage

Our draft decision

Southern Water contacted us prior to submitting its APR data to inform us:

- Of some changes in water consumption as a result of Covid-19; and
- That, as part of its continuous improvement work, it has been undertaking Pulse Interval Timing (PIT) logging in parallel to its historic methods of recording household night use.

The amount of water that customers use at night is an important set of data when estimating leakage rates. Although Southern Water's independent assurer told them that PIT logging is a "significant data improvement", we needed to have confidence for our draft decisions that the reported leakage was calculated in a way that is consistent with how the leakage targets were set. Because this engagement process was ongoing and Southern Water had agreed to supply some further information from its third-party assurance provider, we proposed deferring our decision and the associated ODI payment until 2022. We did this to give us sufficient time to consider the further information so that we would have a clearer understanding of the data and the methodology when we made our determinations in 2022. This involved the deferral of an underperformance payment of £0.398m.

Stakeholders' responses

Southern Water stated that it agreed with deferring the ODI underperformance payment for leakage to 2022 to allow sufficient time to conclude discussions on the restatement of its leakage data for 2020-21, which are designed to ensure that reported leakage is on a fully consistent basis with the PR19 final determination targets.

Consideration of responses and final decision

Given that no stakeholders have provided new information and no stakeholders disagreed with our draft proposals, our final determination remains unchanged from our draft decisions. However, to enable us to fully understand the methodology and basis of the leakage data that the company will report for 2021-22 we require the company to provide:

- A clearly presented comparison of key differences between the two methods and their quantified impact on leakage values; and
- Assurance from the company and an appropriately qualified third party that all leakage performance values (that is, 2020-21 and 2021-22) are reported using a method fully aligned with the three year rolling average baseline.

We will engage with Southern Water on this matter after our final determinations.

As we explained in our draft determination, it is our expectation that there should not be any components of the company's leakage and per capita consumption methodology that are not fully compliant when reporting 2021-22 performance. We will closely assess any non-compliant elements in the 2021-22 APR submissions and will consider what interventions might be appropriate in light of our findings. Should any leakage information be revised or restated, we expect the company to clearly identify any reasons for the restatement and quantify the impact of any changes to data and/or assumptions on reported leakage and on

the leakage baseline if applicable. We will take account of adjustments we have made to the relevant price control in relation to the leakage performance commitment in making future in-period determinations.

2.2.3 Taxation

Our draft decision

In our draft determinations we applied a uniform marginal tax rate of 19% in each company's in-period adjustments model to reflect the headline rate of corporation tax.

Stakeholders' responses

Southern Water requests that we adjust the marginal tax rate in its in-period determination to 0% based on its latest forecast expenditure and to be consistent with its December 2019 PR19 final determination where no tax allowance was made.

Consideration of responses and final decision

We do not consider the company has provided sufficient evidence that it will now incur taxable losses in 2022-23, particularly given the uncertainty around internal business forecasts. We want to maintain a targeted and proportionate assessment during the in-period determinations process. We also note that if the company is not liable to pay corporation tax in 2022-23 as it has no taxable profits, it can carry forward taxable losses to offset corporation tax liabilities in future years. As such, provided the company generates taxable profits in the coming years, we do not consider there is a strong case to change our assumption.

We will therefore maintain the 19% assumption in our final determination for this company. We also note that, as set out in the [PR19 reconciliation rulebook: guidance document](#) (p58), if there is a material impact on customers or companies as a result of a difference between the marginal rate of tax that a company pays in the following charging year and our assumption, we may consider reconciling this at PR24.

2.2.4 Environmental impact of pollutions

Stakeholders' responses

Ten Southern Water customers responded to our consultation, providing various comments regarding Southern Water's performance in relation to pollutions and specifically a spill of sewage that occurred in July 2021. They also raised several questions on broader topics like the use of sewer overflows, executive pay and privatisation of the water sector.

Consideration of responses and final decision

We thank each of these customers for contacting us. For our final determinations, we considered those aspects of the comments relevant to in-period ODI performance in 2020-21 because the final determinations we are making relate to the performance of Southern Water from 1 April 2020 to 31 March 2021. This means that pollution incidents in July 2021 will be covered in the 2021-22 reporting year. We will make our in-period ODI determinations on that reporting year by 15 November 2022.

However, for context, the company's poor performance in 2020-21 has resulted in underperformance payments of £7.718m for pollution incidents and £19.400m for treatment works compliance.

Because some of the broader issues and questions raised do not directly relate to in-period ODIs in 2020-21 we will respond separately to each customer so we can answer the questions individually. We expect to send these individual replies after we have published our ODI final determinations.

2.2.5 C-MeX and D-MeX

Our draft decision

Our draft determination included a C-MeX underperformance payment of £4.906m and a D-MeX underperformance payment of £1.033m, based on assessment of 2020-21 company performance in our draft determinations.

We have taken the data from the company's APR submissions and compared this against the recorded data from our survey agent, Accent.

Further details on C-MeX and D-MeX can be found on the [Customer and Developer Services experience](#) pages of the Ofwat website and in the published C-MeX and D-MeX models.

Stakeholders' responses

We did not receive any specific comments on this issue.

Consideration of responses and final decision

Our final decision is unchanged from our draft determination.

2.3 Payment deferrals and abatements

As set out in our [PR19 reconciliation rulebook: guidance document](#), companies can ask us to defer outperformance or underperformance payments, or abate outperformance payments on individual performance commitments. A deferral results in us delaying when the adjustment will be made to companies' revenue. An abatement results in no adjustment to the company's revenues in relation to the relevant performance commitment in the subsequent charging year.

The company did not request any payment abatements. Based on our assessment of the company's performance, we do not consider any are required. As such, we do not apply any payment abatements in our final determination.

In its response Southern Water said that it had not requested a re-profiling of the in-period adjustments but wanted to discuss with Ofwat the impact of the revenue forecasting incentive mechanism. We have discussed this topic with the company, but it does not affect our final in-period ODI determination

2.3.1 Per capita consumption

Our draft decision

In line with our July consultation proposals, we proposed changing the timing of payments for this performance commitment to end of period. Southern Water did not ask us to defer underperformance payments for its per capita consumption performance commitment for 2020-21.

In our [July 2021 consultation](#) on changing the timing of our determination of the value of ODI payments for per capita consumption performance commitments, we proposed that this should be end of period for all companies. Prior to our July 2021 consultation, we had asked relevant companies to include ODI payments arising from their per capita consumption performance commitments in the deferrals function of the in-period adjustments model. We now consider it would be more appropriate to reflect this proposed treatment through the ODI performance model, ensuring consistency with our policy proposals and ensuring that all ODI payments accrued during the 2020-25 period can be applied at PR24, when we will make our final decisions.

Stakeholders' responses

We did not receive any specific comments on this issue.

Consideration of responses and final decision

Our consultation on moving the timing of the per capita consumption performance commitment to the end of the 2020-25 period has [concluded](#). After carefully considering the responses to that consultation, we have confirmed that ODI payments for per capita consumption performance commitments will be determined at the end of the period for all years within the 2020-25 price control period. Consequently, we have not included any adjustment in relation to this performance commitment in our final determination.

3. Impact of 2020-21 in-period ODI assessment on price controls

3.1 Our final determination

In this section we outline the financial impacts of our final decisions. First, we set out our view compared to the company's requested ODI payments in table 3.1.

Table 3.2 sets out the C-MeX and D-MeX payments included in our final determination.

Table 3.3 summarises the overall ODI payments, after other payments and relevant adjustments, that the company is due based on its performance in 2020-21.

Table 3.4 sets out our final decisions on deferrals and abatements and how we propose that these payments should be applied in 2022-23.

Table 3.5 sets out the changes that we are determining to the company's relevant price controls because of those decisions.

Unless otherwise stated all values are £m in 2017-18 FYA CPIH prices.

Table 3.1: In-period ODI payments for 2020-21 by price control (excluding C-MeX and D-MeX)

This table sets out the in-period ODI payments requested by Southern Water for 2020-21, by price control, and our final determination on these payments after any interventions.

Further detail on how these overall numbers have been derived is set out in the ODI performance model, which we have published on our website as part of the final determinations. Where we have applied interventions, this is set out in "Ofwat_PC_Interventions" in the ODI performance model for this company.

Price control	Company's reported payments (£m)	Our draft decisions after interventions (£m)	Our final decisions after interventions (£m)
Water resources	-0.908	0.000	0.000
Water network plus	-5.786	-5.843	-5.843
Wastewater network plus	-32.725	-32.725	-32.725
Bioresources	-1.286	-1.286	-1.286
Residential retail	-0.600	-0.600	-0.600
Total payments	-41.305	-40.453	-40.453

See section 2 for details of our interventions on the company's performance commitments.

Table 3.2: C-MeX and D-MeX payments

Our final determinations include the following C-MeX and D-MeX payments for this company:

Price control	C-MeX payments (£m)	D-MeX payments (£m)
Residential retail	-4.906	n/a
Water network plus	n/a	-0.495
Wastewater network plus	n/a	-0.538
Total payments	-4.906	-1.033

See section 2 for further details on C-MeX and D-MeX.

Table 3.3: ODI payments including C-MeX, D-MeX, bespoke adjustments and deferrals from 2019-20 (before 2020-21 deferrals and abatements)

This table sets out the composition of total ODI payments, including C-MeX and D-MeX, brought forward deferrals and bespoke adjustments where relevant, but before our final decisions on 2020-21 deferrals and abatements.

Price control	Ofwat view of in-period ODI payments (£m)	C-MeX and D-MeX payments (£m)	ODI payments deferred from 2019-20 (£m)	Bespoke adjustments (£m)	Total ODI payments (£m, before 2020-21 abatements and deferrals)
Water resources	0.000	0.000	0.000	0.000	0.000
Water network plus	-5.843	-0.495	0.000	0.000	-6.338
Wastewater network plus	-32.725	-0.538	0.000	0.000	-33.262
Bioresources	-1.286	0.000	0.000	0.000	-1.286
Residential retail	-0.600	-4.906	0.000	0.000	-5.506
Total	-40.453	-5.939	0.000	0.000	-46.393

Table 3.4: 2020-21 ODI payments after deferrals and abatements

This table sets out our final decisions on the ODI payments to be applied, after deferrals and abatements, as set out in the in-period adjustments model published on our website for this company.

Price control	Total ODI payments (£m, before 2020-21 deferrals and abatements)	Ofwat final deferrals (£m)	Ofwat final abatements (£m)	Total ODI payments to be applied in 2022-23 (£m)
Water resources	0.000	0.000	0.000	0.000
Water network plus	-6.338	-0.398	0.000	-5.940
Wastewater network plus	-33.262	0.000	0.000	-33.262
Bioresources	-1.286	0.000	0.000	-1.286
Residential retail	-5.506	0.000	0.000	-5.506
Total	-46.393	-0.398	0.000	-45.995

See section 2 for our decisions relating to deferrals and abatements for this company.

Table 3.5: Changes to price controls (final determinations)

This table sets out the changes to the level of the company's price controls that we are determining for the Charging Years beginning on 1 April 2022 and 1 April 2023. The details for other charging years are included for completeness and ease of reference. The in-period adjustments model published on our website shows how these changes reflect the impact of our final decisions. See '[Sector overview: Final determinations of in-period outcome delivery incentives for 2020-21](#)' for how we have applied adjustments for tax and inflation.

Price control		2021-22	2022-23	2023-24	2024-25
Water resources (K factors)	Last determination	-2.04	2.55	-0.51	-1.63
	Final determination	-2.04	2.55	-0.51	-1.63
Water network plus (K factors)	Last determination	0.83	0.29	-1.95	-1.55
	Final determination	0.83	-4.00	2.29	-1.55
Wastewater network plus (K factors)	Last determination	0.99	0.32	-1.19	-1.05
	Final determination	0.99	-9.29	8.93	-1.05
Bioresources (unadjusted revenue, UR_t – £m, 2017-18 Nov CPIH prices)	Last determination	46.880	47.216	47.664	48.187
	Final determination	46.880	45.628	47.664	48.187
Residential retail (total revenue, TR_t – £m, nominal prices)	Last determination	50.921	51.613	52.257	52.911
	Final determination	50.921	44.094	52.257	52.911

We have based Southern Water's final determination on the data and commentary provided to us by Southern Water (and, where relevant, other water companies). Should any of this information be revised or restated in future years, we will take account of adjustments we have made to the relevant price control in relation to the performance commitment(s) in question in making future in-period determinations.

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

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