

15 November 2022

# **Final determination of Southern Water's in-period outcome delivery incentives for 2021-22**

## About this document

This document provides notice of our final determination on the extent to which the price controls set by the [PR19 final determination](#) are to be adjusted to reflect Southern Water's performance for the 2021-22 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 adjustments, and our reasons for these, are set out in this document and in our [Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22](#).

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

## Background

At the 2019 price review (PR19), companies made performance commitments, or pledges, to their customers and stakeholders about the service levels they would meet to make progress towards their outcomes. Southern Water's performance commitments for the 2020-25 period are set out in [PR19 final determinations: Southern Water - Outcomes performance commitment appendix](#).<sup>1</sup>

Each performance commitment has an outcome delivery incentive (ODI) that provides either financial or reputational consequences for companies of outperforming or underperforming their performance commitments. Many of the financial ODIs are paid during the 2020-25 price control-period. The reason for this is to bring payments closer in time to when customers experience a given level of performance. The remaining incentives are paid at the end of the period.

ODIs act as an incentive for companies to deliver their committed levels of performance, returning funding to customers for foregone benefits if they deliver less than is expected. Companies that go beyond and deliver greater benefits than expected to customers and the environment can receive outperformance payments.

Southern Water reported its performance against these performance commitments in its annual performance report (APR) in July 2022. We assessed the company's performance against its performance commitments and, in October 2022, consulted on our [draft determinations](#) for companies' in-period ODIs for 2021-22.

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<sup>1</sup> We take account of performance commitments as set out in the PR19 definitions adjusted, if relevant, in accordance with Annex 2 of the company's performance commitment appendix. Annex 2 provides for changes and corrections to be made to 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](#).

In our final determination we set out relevant adjustments to the company's price controls, for one or more future years, in accordance with Part 3A of Condition B of the company's licence. The results of our assessment for 2021-22 will affect Southern Water's customers' bills in the 2023-24 Charging Year.

Further details regarding the responses we received, our final determinations and the adjustments that we have made are presented in sections 1 and 2, and in [Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22](#).

In our [Sector overview Final determinations of in-period outcome delivery incentives for 2020-21](#) we deferred our determination of the value of companies' Per Capita Consumption (PCC) ODI payments for the 2020-21 to 2023-24 charging years to the end of the 2020-25 period. We set out this decision and the reasons for it in the [Consultation on changes to per capita consumption performance commitments – our decision on reporting performance and ODI timing](#) which we published after having considered stakeholder responses to our July 2021 consultation.

## Executive summary

Having assessed Southern Water's performance against its performance commitments in 2021-22, the ODI payments and performance are as reported by the company with the following exceptions:

- C-MeX and D-MeX – we are including a C-MeX underperformance payment of £4.154m a D-MeX underperformance payment of £0.936m;

We have also made the following corrections in relation to Southern Water's performance commitments for 2021-22:

- We are making a positive adjustment of £0.411m to account for restated 2020-21 leakage performance;
- We are making an adjustment on taxation to ensure consistency with PR19. We are changing the tax rate from 19% to 0% for 2021-22 ODI performance and making a bespoke adjustment of £10.789m to remove the tax element of Southern Water's ODI performance in 2020-21.

See section 1 for details of our interventions and policy decisions.

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# 1. Results of our assessment

## 1.1 Interventions and policy decisions

We are not intervening on Southern Water's reported performance and ODI payments for 2021-22 in our final determination. The company has not requested any interventions.

However, we have applied the following amendments to the in-period adjustments model and the ODI performance model:

- an adjustment for restated leakage performance in 2020-21;
- an amendment for tax paid on ODI payments in 2020-21;
- setting a 0% tax rate on 2021-22 ODI payments;
- input of the published value for November 2021 CPIH; and
- an amendment relating to the long-term supply demand schemes PC.

### Leakage and per capita consumption (PCC)

In 2020-21 we deferred £0.398m of underperformance payments for Southern Water's leakage performance commitment. This was because the company reported data in the 2021 APR using a revised reporting methodology. We wanted to be clear about the impact of the methodological changes and ensure the company only benefited from real improvements in performance, not from changes in methodology.

In its 2022 APR, Southern Water submitted leakage performance and three-year average baseline data using both the PR19 methodology and its revised methodology. The APR reported the 2021-22 figure and a revised 2020-21 figure using the PR19 methodology. Southern Water was parallel reporting internally using its revised methodology.

Based on the PR19 methodology, Southern Water reported leakage ODI underperformance payments of £0.265m for 2021-22 and stated that its 2020-21 payment would have been an outperformance payment of £0.014m.

Having assessed the information the company submitted, for draft determination we based payments for 2020-21 and 2021-22 on the data derived using the PR19 methodology. This ensured that there was no benefit from changes to methodology. We included underperformance of £0.265m for the 2021-22 performance and an outperformance of £0.014m for the 2020-21 performance. This meant we included a positive adjustment of £0.411m as one component within the bespoke adjustment to Southern Water's water network plus price control. This was because the company included the deferred value from the 2021 in period determination in its modelling. However, based on the figures derived using the PR19 methodology, the amount included should have been an outperformance of

£0.014m instead of an underperformance of £0.398m. As stated beneath table 2.2, we adjust for the time value of money where applicable.

For the remaining years of the control period, for the purposes of calculating the ODI payments we expect Southern Water to report leakage and PCC performance commitment data using the PR19 methodology. However, to ensure transparency and to support other processes such as WRMPs and the PR24 processes the company should provide this data using both the PR19 methodology and the revised methodology.

## Stakeholders' responses

We did not receive any specific comments on this issue.

## Consideration of responses and final determination

Having received no stakeholder responses on this matter, our final determination on the company's performance payment for this performance commitment remains unchanged from our draft determination, above.

## Taxation

In our PR19 final determination, we did not expect Southern Water to pay tax during the current price control period and so its Final Determination did not include any allowance for tax. On page 58 of the [PR19 Reconciliation Rulebook Guidance](#) we stated that companies should set out their expected marginal tax rate for the following charging year in their requests for an in-period determination, including whether they expect to pay corporation tax and any capital allowances, with appropriate evidence. We said we will take this information into account when making our determination.

In its APR22, Southern Water submitted information to support its view that it did not expect to pay tax within the 2020-25 period, due to its high capital allowances and taxable losses that reduce its future tax liabilities. Based on the information provided, and subject to further clarification from the company ahead of the final determination, we adjusted the modelled tax rate. Consequently, in modelling its draft determination for 2021-22 performance, we changed the assumed tax rate from 19% to 0%. We also adjusted the tax element of the company's 2020-21 ODI performance, through a bespoke adjustment of £10.789m split between the water network plus, wastewater network plus, bioresources and residential retail price controls. We said that subject to our decision for final determination, we will keep the company's position under review and if its circumstances change, for example, if the company were to pay tax in the current period, we may revisit this adjustment.

## Stakeholders' responses

In its response, which is published on our [website](#), Southern Water agreed with the key interventions and alterations. The company said it was pleased Ofwat had aligned their tax

position of 0% for 2021/22 and have allowed for a bespoke adjustment of £10.789m to true-up 2020-21 ODI tax treatment. The company noted that the default is to recover this in 2023-24 charging year and it requested the flexibility to consider recovering this either in full or in part across the remainder of this AMP (2023-24 or 2024-25).

### **Consideration of responses and final determination**

Having reviewed the company's responses on this matter we asked it to confirm details of any proposal to defer to abate any payments in order to achieve the flexibility it referred to. The company responded telling us that, after further consideration, it was not putting forward any proposals. So, our final determination on this remains unchanged from our draft determination, above.

### **November 2021 CPIH**

We applied a correction to the company's in-period adjustment model to include the Office of National Statistics (ONS) published value of 114.1 for November 2021 Consumer Price Index (including housing). This replaces the value of 112.6 Southern Water had used in the model.

### **Stakeholders' responses**

Southern Water has stated that it agrees with the correction proposed in our draft determination.

In addition, it said that it wishes to ensure consistency in the inflation of the ODIs in the generation of the Ks, and the inflation when setting its charges. The final in-period determination for 2021-22 will be published prior to the publication of the November 2022 CPIH number. Thus, the publication will include a forecast inflation number. The company believes that Ofwat should encourage companies to update the in-period determination post publication with the actual November 2022 inflation. Therefore, when inputting the Ks in future years these will be correct as per the correct November inflation.

### **Consideration of responses and final determination**

Having considered stakeholders' responses on this matter, our final determination on this remains unchanged from our draft determination, above.

In [PR19 reconciliation rulebook consultation: final policy approach and response](#) we acknowledge, that because of the timing of the in-period determination process, we will need to use a forecast of November to November inflation in the in-period determinations. We also confirmed that we do not intend to correct for differences with actual inflation because we continue to consider the impact of the forecasting approach will be relatively minor and we committed to maintaining this forecasting approach during the 2020-25 period for the in-period determinations of ODIs.

## Long term supply demand schemes

We made amendments (recorded in the Ofwat IPD22 actions worksheet) to make three corrections to Southern Water's ODI performance model. Only one of these corrections had a financial impact on ODI payments and that was for this performance commitment (PR19SRN\_WN13). The company selected 'true' in row 36 of the PC\_Company\_input worksheet when it should have been false because the ODI for this PC only applies in 2024-25. The financial impact of this correction was to decrease the sum of the underperformance shown in the initial calculation of end of period revenue adjustment by price control by £16.199m. This change was visible in cells C19:C25 of worksheet 3H but it made no financial difference to our 2021-22 in-period ODI draft determinations.

## Stakeholders' responses

We did not receive any specific comments on this issue.

## Consideration of responses and final determination

Having received no stakeholder responses on this matter, our final determination on this performance commitment remains unchanged from our draft determination, above.

## Other stakeholders' responses

A Southern Water customer responded to our consultation. The full customer response, with personal details redacted, is available on our [website](#) but in summary, they:

- Expressed concern regarding inadequate investment in sewer infrastructure and water company profits
- Asked how funds from fines are spent

## Consideration of responses and final determination

We have sent a direct response to the customer addressing the specific points raised. In summary we have stated that:

- The operational and cultural failings of Southern Water are what led us to imposing a significant sanction on the company in 2019. Southern Water acted in a way completely counter to what customers expect and deserve which is why we imposed £126 million in penalties and payments on the company. Fines levied on Southern Water by Ofwat and the Environment Agency will be directed back into the Treasury and will be used accordingly;
- In addition to the above fines, the company's poor performance in 2021-22 has resulted in expected underperformance payments of £28.3 million. This money is returned to customers and should take the form of reductions in customer bills;

- We have recently [published proposals](#) to give Ofwat extra powers to stop water companies making dividend payments if their financial resilience is at risk. Our position on company profits and dividends is further detailed on our [website](#);
- To support compliance with environmental permits at PR19, amongst other funding, Ofwat allowed all enhancement schemes requested by companies to enable delivery of the Water Industry National Environment Programme (WINEP) set by the Environment Agency in England and the National Environmental Programme set by Natural Resources Wales in Wales. This equates to around £5bn, including £530 million specifically for schemes to increase FFT (flow to full treatment) capacity at treatment works, £440 million for storage schemes at treatment works, and £43 million to install new monitors on storm overflows. Companies are fully responsible for meeting their legal obligations, including taking prompt action where any shortcomings or significant risks are identified.

This does not directly alter our final determinations.

## 1.2 C-Mex and D-Mex

### Our draft determination

On 21 September we published the relative performance of all companies. Our draft determination included a C-MeX underperformance payment of £4.157m a D-MeX underperformance payment of £0.936m, based on our assessment of 2021-22 company performance.

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

Southern Water did not comment on this issue. However, another company identified a minor technical inconsistency between the reporting of C-MeX scores in the reconciliation model and the expectation in the [RAG 4.10 guidance](#), which states that scores should be rounded to 2 decimal places.

### Consideration of responses and final determination

To ensure the C-MeX reconciliation model operates consistently with RAG 4.10 and the [PR19 Reconciliation rulebook](#) guidance, we have updated the model to round the input scores to 2 decimal places. This has a minor impact on the payment values calculated by the model. For Southern Water, this decreases its C-MeX underperformance payment by £0.003m to £4.154m, whereas D-MeX payment remains unchanged from our draft determination.

## 1.3 Payment deferrals and abatements

As set out in our [PR19 final determinations](#) and the [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.

With the exception of what it told us in its consultation response about taxation, described in section 1.1, Southern Water did not request any payment deferrals or 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 deferrals or abatements in our final determinations.

In our Final Determination of Southern Water's in-period outcome delivery incentives for 2020-21, we deferred £0.398m of the company's underperformance payment in relation to its leakage performance commitment. Because this deferral was for 2020-21 leakage we have accounted for this in the way described in section 1.1.

## 2. Impact of 2021-22 in-period ODI assessment on price controls

### 2.1 Our final determination

In this section we outline the financial impacts of our final determinations.

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

**Table 2.1: Change between draft and final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)**

This table sets out the change between our draft and final determinations.

Price control	Draft determination on total ODI payments to be applied to customer bills in 2023-24 (£m)	Change between draft and final determination (£m)	Final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)
Water resources	0.511	0.000	0.511
Water network plus	-2.503	0.000	-2.503
Wastewater network plus (WaSCs only)	-22.214	0.000	-22.214
Bioresources (WaSCs only)	-0.976	0.000	-0.976
Residential retail	-3.115	0.003	-3.113
<b>Total</b>	<b>-28.297</b>	<b>0.003</b>	<b>-28.294</b>

**Table 2.2: Final determination on adjustment to 2023-24 price controls as a result of performance against ODIs**

This table sets out our final determination on the ODI payments to be applied to price controls in the 2023-24 charging year after accounting for:

- the in-period ODI payments for each company based on their performance in 2021-22;
- our final determination on these payments after any interventions;
- our final determination on 2022-23 deferrals and abatements;
- bespoke adjustments, including prior year restatements, where relevant; and
- our final determination on C-MeX and D-MeX payments.

For further details on the interventions, deferrals, abatements and bespoke adjustments, see section 1. This final determination on the ODI payments to be applied for Southern Water is also set out in the in-period adjustments model published on our website.

Final determination of Southern Water's in-period outcome delivery incentives for 2021-22

Price control	Company's reported ODI payments (£m)	Ofwat FD interventions (£m)	ODI payments deferred from 2020-21 (£m)	Ofwat FD deferrals (£m)	Ofwat FD abatements (£m)	Bespoke FD adjustments (£m)	C-MeX FD payments (£m)	D-MeX FD payments (£m)	Final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)
Water resources	0.511	0.000	0.000	0.000	0.000	0.000	0.000	0.000	<b>0.511</b>
Water network plus	-3.715	0.000	-0.409	0.000	0.000	1.889	0.000	-0.268	<b>-2.503</b>
Wastewater network plus (WaSCs only)	-29.610	0.000	0.000	0.000	0.000	8.064	0.000	-0.669	<b>-22.214</b>
Bioresources (WaSCs only)	-1.286	0.000	0.000	0.000	0.000	0.311	0.000	0.000	<b>-0.976</b>
Residential retail	-0.600	0.000	0.000	0.000	0.000	1.642	-4.154	0.000	<b>-3.113</b>
<b>Total</b>	<b>-34.700</b>	<b>0.000</b>	<b>-0.409</b>	<b>0.000</b>	<b>0.000</b>	<b>11.905</b>	<b>-4.154</b>	<b>-0.936</b>	<b>-28.294</b>

**Table 2.3: Breakdown of bespoke adjustments**

This table provides a breakdown of the bespoke adjustments included in our final determinations.

Price control	Prior year restatements (£m)	Prior year C-Mex indexation (£m)	Prior year D-Mex indexation (£m)	Time value of money adjustment on prior year total (£m)	Green recovery (£m)	Total bespoke adjustments to be applied to customer bills in 2023-24 (£m)
Water resources	0.000	0.000	0.000	0.000	0.000	<b>0.000</b>
Water network plus	1.805	0.000	0.031	0.054	0.000	<b>1.889</b>
Wastewater network plus (WaSCs only)	7.802	0.000	0.033	0.229	0.000	<b>8.064</b>
Bioresources (WaSCs only)	0.302	0.000	0.000	0.009	0.000	<b>0.311</b>
Residential retail	1.292	0.303	0.000	0.047	0.000	<b>1.642</b>
<b>Total</b>	<b>11.200</b>	<b>0.303</b>	<b>0.064</b>	<b>0.338</b>	<b>0.000</b>	<b>11.905</b>

The prior year C-Mex and prior year D-Mex values correct an error in how the C-Mex and D-Mex models applied indexation in 2020-21. Where applicable we adjust for the time value of money.

**Table 2.4: Changes to price controls (final determinations)**

This table sets out the impact of our final determination on the company's price controls, as set out in the in-period adjustments model published on our website. See [Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22](#) for how we apply adjustments for tax and inflation.

Price control		2021-22	2022-23	2023-24	2024-25
<b>Water resources (K factors)</b>	Previous determination	-2.04	2.55	-0.51	-1.63
	Revised	-2.04	2.55	1.54	-3.45
<b>Water network plus (K factors)</b>	Previous determination	0.83	-4.00	2.29	-1.55
	Revised	0.83	-4.00	0.69	-0.10
<b>Wastewater network plus (WaSCs only)</b>	Previous determination	0.99	-9.29	8.93	-1.05
	Revised	0.99	-9.29	2.90	4.29
<b>Bioresources (WaSCs only)</b>	Previous determination	46.880	45.628	47.664	48.187
	Revised	46.880	45.628	46.688	48.187
<b>Residential retail (total revenue, TRt – £m, nominal prices)</b>	Previous determination	50.921	44.094	52.257	52.911
	Revised	50.921	44.094	48.454	52.911

We have based Southern Water's final determination on the data and commentary provided to us by Southern Water. 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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