

Draft Determination of in-period ODIs

South East Water response

21 October 2022

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1. Introduction

We would like to respond on two ODIs included in our Draft Determination - interruptions to supply and WINEP schemes. In both cases, we feel that Ofwat's draft determination is technically incorrect, but perhaps more significantly is not consistent with good regulatory practice.

We would like to make some general observations about each of these ODIs, and then to address some of the specific points in the Draft Determination.

General Points

The interruptions to supply ODI is designed to give an incentive to companies to avoid inconveniencing customers by interrupting their supply. The ODI was intended to incentivise good practices such as operating networks to avoid burst mains; reacting quickly to restore supplies on failure; finding alternative ways of supplying customers in adversity; minimising the length of interruptions and carrying our planned maintenance in a way that avoided interruptions. It was not designed to inappropriately penalise companies for the incidence of bad weather, or the resilience of third parties such as electricity distributors.

The incidence of storm Eunice and the storms Franklin and Dudley in February 2022 were a highly unusual event. There is some debate about whether more similar events should be expected as a result of climate change, but historically speaking, the incidence was unprecedented. The incidence is not something that either UK Power Networks or South East Water could reasonably be expected to have anticipated or made long-term plans for. If such an incident does not meet the bar for an exclusion from the Interruptions to Supply ODI, then it is hard to imagine any incident that might.

We are concerned about what Ofwat is intending to incentivise here. We don't think it is in customers interests for us to construct sufficient backup generation facilities that we can continue to supply customers without interruption in the case of a total power loss across our region. Such a response would be disproportionate, not in the customer interest and have a huge carbon footprint.

It is worth restating that we already have plenty of incentives to avoid such incidents already. These storms cost us in the region of £2m in various operational responses. As a water company, these kind of costs are a legitimate risk associated with our business. To be inappropriately penalised on top of this by a regulator, doesn't appear to serve any purpose. It simply increases the general risk associated with the industry which would lead to a higher cost of capital.

The purpose of our bespoke WINEP ODI was to incentivise us to deliver on our commitments to customers and the environment. We have over-delivered on the environment, both in the past and in this AMP, yet Ofwat is applying an unexpected interpretation to a bespoke ODI, and suggesting that we should pay a penalty. This appears to be an example of inflexible regulation, inadvertently incentivising the opposite of what is intended

Retrospective regulation

In the case of both Interruptions to Supply and WINEP, Ofwat appears to be changing the PR19 Final Determination. SEW expected that Ofwat would exclude civil emergency situations from the Interruptions to Supply ODI and that it would accept the views of the Environment Agency and Natural England when they changed WINEP deadlines. It is contended here, that this is a

reasonable interpretation of the PR19 FD, and that to deny us these exclusions is effectively rewriting the FD.

WINEP Deadlines and innovation

In the case of WINEP deadlines, we are concerned that Ofwat's interpretation of this bespoke ODI will have unintended consequences, disincentivising both innovation and responsible environmental decision making. We consciously included innovative projects in our PR19 WINEP programme. If Ofwat doesn't accept that innovative projects are liable to evolve during their lifetimes and that this will result in changes to completion dates, then it will disincentivise companies from innovating.

2. Specific Responses to Ofwat's draft determination

In this section we address specific points made in Ofwat's Draft Determination

PCs are reasonable

Extract from Ofwat Draft Determination document (p5):

We consider that the PCs and ODIs consulted on and set at PR19 were reasonable. As regards the treatment of events raised by the company, our PR19 methodology, confirmed in the PR19 final determinations, was to include the impact of events such as extreme weather in reported performance. In general, PR19 performance commitments provide few exclusions because for adverse events, such as weather events, we want companies to be incentivised to minimise the impact on customers. These are precisely the events we want the sector to be resilient to.

At PR19, we also stated the importance of companies having confidence that performance commitments will not change during the price control period. We said that if there is a potential for such change, this could lead to a disconnect between the cost/service package specified at the start of the period and what is delivered; potentially incentivise companies to focus on convincing Ofwat of the need for a change as opposed to focusing on delivering what matters to customers; and add complexity.

We do agree with this statement in general terms, but it fails to recognise that the ODIs that were set included exclusions within their definition. As such exclusions are a relevant part of the mechanism. We also agree that performance commitments should not change during the period, but it seems that Ofwat are changing the commitments, by disallowing reasonable exclusions.

The cost/service disconnect referred to is mischaracterised, as the costs in question are almost entirely backward looking and therefore did not include the cost of such weather events. This kind of storm return frequency is well in excess of anything which occurred during the period used to create the cost/service package.

To suggest that we concentrate either on convincing Ofwat of the need for a change or delivering what matters to customers, is at best a misguided interpretation of the application of the exclusion. Our focus on dealing with these events doesn't even consider the ODI, our focus is entirely on customers, domestic, business and most importantly customers in vulnerable situations. Any consideration of an exclusion comes much later, and only after all customers are back on supply.

In seeking an exclusion, we have merely followed the approach laid down within the assessment of the application of the ODI framework, which was clearly stipulated in the Final Determinations for all companies.

Within the reporting guidance there is a section entitled: "Exclusions". We interpreted (and contend that it was reasonable to interpret it) as recognising that some circumstances should mean that it is not appropriate or indeed fair to penalise companies who have already had to deal with a significant event not caused by the water service. Such events result in considerable costs, resource, negative impact to reputation and general impact via penalty mechanisms such as C-MeX.

The exclusion quoted in effect describes a regionally significant event, not of our making and involving many other parties, but uses the civil emergency descriptor to capture this. We fail to see under what circumstances this exclusion would occur if it doesn't apply in this instance and as such it suggests that this is an irrelevant exclusion clause. If the clause is indeed to be disregarded in this way, that clearly represents a change to the ODI performance commitments which we all agree should not be changed.

Insufficient Evidence

Extract from Ofwat Draft Determination document (p6):

We consider that the company provided insufficient evidence that relevant Category 1 responders treated Storms Eunice, Dudley and Franklin as emergencies. In Sussex, an Emergency Strategic Command Group and an Emergency Tactical Coordinating Group were established, led by Sussex Police with UKPN and South East Water as Tier 2 responders. A regular meeting and update structure was established to help co-ordinate a response, but there is insufficient evidence that multi-agency response arrangements were activated beyond this. No major incidents were declared. Nevertheless, we went on to consider whether we should intervene to make changes to the company's ODI payments.

We are not sure why Ofwat has not seen sufficient evidence. We attach our submission of evidence from July 2022 as Appendix 1. We also attach Appendix 2, which is the relevant extract of the Civil Contingencies Act, which makes the definition of an emergency clear, and specifically refers in (2) (e) to a disruption to water supplies as an example of an emergency. In addition, we attach Appendix 4, which is the minutes of the Sussex Resilience Forum from 21st February, which shows the meeting included the Police, the Fire Service (ESFRS is East Sussex Fire and Rescue Service) and the Military JRLO. We understand these as Category 1 responders. These minutes also refer to the interruptions to supply to hospitals which resulted from the power outages, which clearly constitute a threat to human welfare as defined in the given extract of the Civil Contingencies Act in its definition of an 'emergency'.

Supply Interruptions Performance

Extract from Ofwat Draft Determination document (p6-7): We considered South East Water's performance on the water supply interruption PC. South East Water's performance this year is the worst in the sector at 1 hour 12 minutes 6 minutes and 33 seconds, but it is not evident that the company faced worse conditions compared to other companies in the region. Further, its performance on its water supply interruptions PC in 2020-21 was also poor. We note that, both this year and last, this poor performance meant that the company went beyond the underperformance collar. This means the company has already benefited from the protection provided by the PR19 package (avoiding around £11.115m in underperformance payments as a result). For the unplanned outage PC, the company reported no performance payments in 2021-22 and no performance payments in 2020-21.

We fail to see the relevance of the points raised in this section. Historic performance or the use of collars are not relevant to the exclusion for which we applied. Collars were indeed part of the

package as described, and so were exclusions. The performance in previous years were also extreme weather related, resulting from events in excess of 1 in 100 years frequency. Although these incidents also involved LRFs, it should be noted that we did not claim exclusions for these, as they did not fit the described exclusion as it does in the case of storm Eunice.

+/-3% of RoRE test

Extract from Ofwat Draft Determination document (p7):

We considered South East Water's overall performance against all its performance commitments for 2021-22 (including C-MeX and D-MeX). The company reported a net underperformance of £2.279m and including C-MeX and D-MeX underperformance payments, this increased to £3.193m. We note that this is not out of step with the range, calculated at PR19, of out/underperformance payments that the company might reasonably be expected to incur during 2020-25 and the broad potential RoRE five year average range for ODIs set out in the PR19 methodology of +/- 1 to +/- 3%. This is also the case, when we consider South East Water's overall performance across 2020-21 and 2021-22.

This assessment is concerning, implying that: it is acceptable to not accept a valid exclusion if overall the total reward/penalty range is within a reasonable expected range and ignore whether the exclusion is relevant or indeed fair in that assessment.

It is vital that regulators are seen to be fair and apply mechanisms in a predictable and consistent manner. Neither of those are being achieved by applying this test to an exclusion if a company which incurs material penalties, entirely beyond their control, can expect Ofwat to apply a penalty to them as long as it does not exceed 3% of RoRE. It actually implies that if we had performed worse in other PCs, this exclusion would have been allowed, which is surely a perverse interpretation.

The effect on incentives

Extract from Ofwat Draft Determination document (p7):

We consider that loss of supply is perhaps the most serious water service failure, especially for vulnerable customers. The impact for customers of these service interruptions were severe. Around 39,000 South East Water customers were without water for between 1 and 126 hours. This is why the PCs are designed to apply strong incentives to companies to minimise any impact or lack of supply and to protect the environment. This includes low probability high impact events, with resilience being a key part of the PR19 process. We consider that excluding the impact of these events may weaken the company's incentives in relation to such events in the future and managing the impact on customers.

We (and our customers) consider water quality to be the most serious water service failure. This paragraph seems to suggest that the ODI incentives are the only ones in play. We disagree strongly. Our company has a very strong public service ethos at all levels, which leads to an overwhelming desire to maintain supplies. They are our customers, and we care deeply about the impact on them above anything else, and this can be seen in the actions of our teams on a daily basis. We voluntarily paid compensations outside the GSS regime and went to speak to our communities to explain and listen to customers concerns amongst many other actions and initiatives. To suggest the size of the ODI penalty has any influence on our desire to maintain supplies given all these other larger factors is incorrect. Our issue is not to challenge the importance of interruptions but merely to have a regulatory mechanism that is fairly and consistently applied.

The consequences of intervening or not intervening

Extract from Ofwat Draft Determination document (p7):

We considered whether not intervening was likely to create unwanted incentives to invest so as to minimise risk in an inefficient way, which would not be in customers' interests.

Companies are subject to both upside and downside risk from ODIs. And companies need to manage resilience through base expenditure and, where appropriate, can request enhancement expenditure to reduce risk. We set out our criteria for resilience enhancement expenditure in the PR24 draft methodology. As part of this, companies will need to undertake a systematic assessment of risks to identify potential schemes. For each scheme, they will then need to quantify the impact on risk of the proposed expenditure. Proposed options will need to be cost beneficial, best value and have customer support.

We have no issue with this but in this case we were faced with weather threats orders of magnitude above anything we have seen before. The most number of assets we have lost simultaneously due to power historically was in single figures. We do indeed consider the risk of these kind of events but the extremely low probability at time of assessment is likely to fail the test as to whether it was good use of customers' money.

Ofwat should use a different lens to assess unwanted incentives, if we cannot rely on an assessment that considers any other factors at all and is a simple application of a formula with no collar or exclusions this represent a significant and unquantified risk to companies

If Ofwat persists in penalising companies in this manner then incentives related to ODIs become really significant, and the rational response would be to divert resources from elsewhere to avoid or reduce the impact of low probability, high consequence events not caused by our service events. This could be at the expense of investment that creates long term stability of our service such as asset maintenance where the incentives have different properties. We don't believe this is not in anyone's best interest, least of all customers

Water Industry National Environment Programme (WINEP)

Extract from Ofwat Draft Determination document (p8):

South East Water asked us to intervene to decrease its £0.325m underperformance payment in relation to its WINEP performance commitment. The company presented evidence that it has received extensions to the deadlines for six WINEP schemes from Natural England and the Environment Agency, which it states allow more data to be collected. Whilst the in-period delivery of WINEP is a matter for the company to agree with the environmental regulators, the definition of the company's WINEP PC, PR19SEW_H.3, states that it is "limited to the 59 schemes classified by the Environment Agency as having 'Green' status as at 1 April 2019 and the Bewl-Darwell Transfer scheme with reference 7SE200012. The company referred us to the fact that its PC definition required that "all elements of its 2020-25 period WINEP obligations are delivered to agreed scopes and to final statutory deadlines." At PR19 we addressed this issue with South East Water and on page 17 of PR19-final-determinations-South-East-Water---Delivering-outcomes-for-customers-final-decisions.pdf (ofwat.gov.uk) we stated that we do not allow the company to retain flexibility in its WINEP to make changes in-period. Draft determination of South East Water's in-period outcome delivery incentives for 2021-22

As we subsequently clarified in section 1.5 of IN2201 our policy is that we would not expect to make changes to financial PCs simply because of WINEP changes. As a result, we are not intervening to change the underperformance payment of £0.325m.

We fail to see how applying this approach is in the best interest of customers or the environment. We believe the penalty is inappropriate because it creates a perverse incentive both for customers and environment.

Extensions to statutory deadlines are agreed to ensure that we get to the bottom of the 'reasons for environmental failure'. It is important that this is done, as by doing this we can ensure that any interventions made (for example closure of abstractions and replacement with new abstractions) are only done where they are both cost effective and the right solution to negate environmental impacts. It is only in extreme circumstances that we would apply for an extension to a statutory

deadline, and our reason for doing this would be to ensure that we do not close of sustainable abstractions.

For the schemes outlined, we could have delivered outputs in 2022 but this would have led to significant investment with uncertain environmental effects, and a failure to achieve best value for customers. We feel it would be unethical to close sources without understanding their current impacts together with the environmental impacts of the solutions replacing them.

The way that this bespoke ODI is being interpreted by Ofwat incentivises us to close the investigation without understanding the issue fully and would undoubtedly lead to both inappropriate spend and environmental impact.

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