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IPD2022 Consultation response  
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Dear colleagues

## **DRAFT DETERMINATION OF SOUTH WEST WATER'S IN-PERIOD OUTCOME DELIVERY INCENTIVES FOR 2021-22**

We welcome the opportunity to respond to Ofwat's Draft Determination of South West Water's (SWW) in-period outcome delivery incentives for 2021/22. We have focused on the specific interventions Ofwat has set out in its Draft Determination.

### **Overview**

We undertake a thorough review of our ODI performance on an ongoing basis. Ahead of any reported performance, we engage third party assurance providers who challenge and assess our reported position relative to the ODI regulatory framework. This gives us high confidence in the ODI performance that we put forward in our APR. As such, we are disappointed with the interventions Ofwat has made in respect of sewer blockages and the treatment of Carland Cross specific incident that impacted both the resilience in the round and water supply interruptions ODIs.

We believe the position we had proposed for each of those ODIs was proportionate, and importantly consistent with required regulatory duties and principles. And in our recent testing with customers of relevant sections of Ofwat's Draft Determination has confirmed that our position is in line with the strong views expressed by our customers.

We set out our response below, and do urge Ofwat to reconsider the Draft Determination and in the proper exercise of its discretion so as to not levy any penalty for the impacts outlined below:

## **Carland Cross – adjustments to resilience in the round and water supply interruptions ODIs**

The Cornwall spine main, serving the vast majority of Cornwall, is twinned for c. 70km with numerous cross connections between the mains, essentially forming a ladder. These cross connections provide resilience in the event of failure of one of the mains – a rare event. The connections work by allowing sections to be valved out in the event of a failure or to facilitate maintenance activities. Offtakes from the trunk mains that supply service reservoirs and also direct into distribution, can generally be fed from either main. Our resilience and contingency plans are based on the location of the cross connections and the valving required to isolate sections of the spine main.

The Carland Cross incident is an exceptional event well outside of what is reasonable to plan for - akin to a “meteor hitting a treatment work” – that is a type of event that should never happen and we cannot and should not attempt to invest to prevent it. A key and unique aspect of this event is the two strategic mains being struck with the second strike being a grossly negligent act undertaken on notice (i.e. a third party contractor continued in the knowledge that a first main had been hit), and therefore not an accident.

The circumstances surrounding the Carland Cross incident were set out in a comprehensive report provided to Ofwat in November 2021. In summary:

- On Monday 30 August 2021, a third party contractor of Scottish Power Renewables (UK) Limited (SPR) cut through one of SWW’s strategic mains to Cornwall, near Carland Cross, with a mole plough.
- The contractor proceeded to travel a further 80-100m, cutting through SWW’s duplicate strategic resilience main resulting in a loss of supply to customers in Mid and West Cornwall.
- SWW had provided information to SPR and its contractors, putting them on notice of the location of the water mains and the need to avoid them before ploughing.
- SPR and its contractors failed to follow SWW guidance and breached standard industry practice. The actions were negligent and contrary to health and safety standards set by HSE.
- Through swift mobilisation of staff, SWW restored water supply to over 80% of affected customers within 12 hours, and to more than 95% within 24 hours.
- Customer research demonstrates that 90% of those surveyed perceived SWW’s handling of the situation to be at least satisfactory, while 84% through the time taken to restore supplies was at least acceptable.
- 97% of customers were satisfied with the compensation they received.
- Our more recent customer research, conducted via focus groups, shows that customers do not see a basis for penalties to apply and do not see how they are best served with these monies being levied.

It is beyond question that SWW bore no responsibility for the cause of the incident or exacerbated its consequences. There was nothing that SWW could reasonably have done to prevent the incident and SWW did all it could to restore water supplies promptly and pay compensation using systems it had set up, in place and ready to go with its contractors.

Carland Cross is an example of a negligent act by a third party for which we are seeking compensation. We believe it is important that penalties for poor performance are targeted, justified and rational and that Ofwat has a duty to consider these aspects as part of its determination.

**In the Draft Determination, Ofwat makes six key points as the basis for not excluding this from the ODIs.**

- PR19 performance commitments provide few exclusions so that companies are incentivised to minimise the impact of adverse events
- PR19 performance commitments should not change during the price control period
- Reporting of PR19 performance commitments needs to reflect underlying performance
- The performance is within reasonable RORE ranges
- Intervening could cause unwanted incentives
- Intervening is not in line with Ofwat's duties to protect customers and enhance resilience

We consider each point in turn.

***PR19 performance commitments are clear and provide few exclusions so that companies are incentivised to minimise the impact of adverse events***

We consider that Ofwat are taking a very precise interpretation of exclusions and whether the specific circumstances are listed in the PR19 Final Determination outcomes definition appendices.

In the Draft Determination, Ofwat states that in general PR19 PCs provide for few exclusions – to incentivise and minimise the impact of adverse events on customers. Ofwat give the example of asset failures caused by third parties.

We acknowledge that the avoidance or amelioration of third party events where the asset failure or operational response has an adverse impact on customers are incentivised by not excluding them from these ODIs. Indeed, there were c.50 such examples with a total impact of c.22 seconds that have not been excluded during 2021/22.

We agree that weather events and asset failures should not be excluded. However, Carland Cross sits outside of this, caused by neither weather nor the failure of our assets due to lack of maintenance or resilience. It is exceptional in terms of its nature and its size.

We have provided sufficient information to Ofwat to establish that this event was genuinely exceptional, and whilst there are no explicit exceptions specified in the ODI definitions there are wider considerations within Ofwat's duties that should explicitly be recognised by Ofwat, and complied with in reaching its final decision. As Ofwat set out in the Draft Determination, Ofwat has the discretion to do so.

***PR19 performance commitments should not change during the price control period***

Ofwat states in the Draft Determination the importance of companies having confidence that performance commitments will not change during the price control period. If there is a potential for change, this could lead to a disconnect between the cost/service package specified at the start of the period and what is delivered.

In reality we have already seen welcome flexibility on both the level of ODIs (e.g., for Green Recovery investment) and in exceptional cases for the impact of the Covid-19 pandemic. Further changes to ODIs are likely as part of any transitional funding that is put agreed as part of the discussions with Defra on an early start programme for PR24. This demonstrates that performance commitments can and should change under certain circumstances.

## ***Reporting of PR19 performance commitments needs to reflect underlying performance***

The Carland Cross event is not an example of poor performance on the part of SWW, as inferred by the way that in-period ODIs have been communicated by Ofwat. As was stated in the Ofwat press notice 32/22 and on social media *“When it comes to delivering for their customers, too many water companies are falling short, and we are requiring them to return around £150m to their customers. We expect companies to improve their performance every year, where they fail to do so we will hold them to account.”*

The Draft Determinations propose a very substantial financial penalty in circumstances in which SWW was utterly blameless. However, as shown in our recent research with customers and observations in the media following publication of the Draft Determination, the wider stakeholder community do register penalties have been levied and, on that basis, conclude that SWW was at fault, as otherwise there would be no reason to penalise SWW. This does suggest that the ODI regime is not being used as intended to incentivise and communicate underlying performance.

## ***The performance is within reasonable RORE ranges***

Ofwat argued forcefully during PR19, and particularly during the CMA process, that the regulatory framework is not asymmetric and that the potential to suffer penalties is evenly balanced with scope to earn rewards. However, it is difficult to imagine what the upside equivalent of Carland Cross type incident could be. Ofwat’s refusal to give a dispensation in this case therefore reinforces the narrative that there is an inherent skew that needs to be accounted for elsewhere within the risk and return framework

In the Draft Determination Ofwat assesses the impact of caps and collars – this event falls outside of an event that could reasonably be planned for. It is not foreseeable that SPR’s contractors would behave so far outside standard industry practice and that they would continue into the second resilience main after damaging the first. This is an asymmetric “meteor” type event which has no equivalent upside that could offset this.

Overall, Carland Cross is not reflected in the cost/service package – and it is not in customers’ interests for the cost/package to reflect such risks. Indeed, it is an event so exceptional it could not be anticipated at PR19 and was not included in the RoRE modelling. This is despite asset planning for resilience that considers very low probability/high consequence events (such as the removal of a water treatment works due to a natural disaster such as a meteor). The strategic resilience main already is the product of such planning, and on any reasonable view that it is sufficient.

Therefore our risk reward package is based on P10 and P90 assessments and events of this magnitude were never included in these assessments, and would only be included if a P0 / P100 approach was adopted, as this event is very close to a P0 assessment – i.e., it has a probability close to zero and therefore sits outside the RoRE modelling.

## ***Intervening could cause unwanted incentives***

The incident is exceptional, and has multiple incentive implications and policy matters concerned. These are explored below.

We agree that loss of supply is one of the potentially severe impacts on customers, and potentially vulnerable customers. However, in this case the customer service and operational response met all best practice in the water sector and we have provided sufficient evidence to demonstrate this, despite the cause of the event being extremely unlikely. Ofwat suggests that excluding this event may weaken incentives to manage such events for customers in the future, but this is not borne out, as evidenced by our actual response to this event.

The 'resilience in the round' measure is a voluntary, bespoke PC/ODI. This is relevant, as SWW did not have to put forward this particular measure, but its inclusion in the PR19 FD was in customers' interests. If SWW now suffers excessively as a result of its initiative, through no fault of its own, this could be expected to have unwanted impacts at future price reviews.

Furthermore, not intervening creates the unwanted incentive to invest to minimise risk. However, we would argue that additional resilience would not be appropriate to be incentivised.

Indeed, at PR19 our resilience planning identified number of potential trunk mains and critical crossing duplication schemes. However, none of these were associated with the Cornwall Spine Main given the level of resilience inherent in the system. The additional investment options that would have had to have been in place to potentially reduce some of the impact of the event of a complete failure of both water mains in the same location is summarised below:

- A third main – although whether this would have provided mitigation in this event would be dependent on proximity to the existing twin mains. As the third party contractor did not stop after hitting two mains, we have no reason to believe a third main would not also have been damaged by the trenching machine. A third main would be surplus to requirements under normal operations and would require additional operational activities to keep the main clean and in service for use under these circumstances. This would not efficient, economical or in the interests of consumers.
- An alternative supply route – in practice this is highly unfeasible as the alternative route would still need to originate from the same treatment works and service reservoir and connect into all offtakes along the existing route
- Additional strategic storage and/or pumping - the benefits of this are dependent on the location of the strategic storage/pumping in relation to where the mains failure occurs. For example, strategic storage located further up the systems provides storage benefits to more customers however, the length of downstream main after the storage is longer and therefore more likely to experience an event. Strategic storage/pumping at every significant off take is unrealistic over a distance of 70km.

We believe Ofwat has more than sufficient evidence that based on the overall impact of Carland Cross, applying the incentives goes beyond the reasonable expectations that either water companies, their customers or stakeholders would have from the ODI framework. Moreover, we would argue that intervening removes unwanted incentives to overinvest as we look to manage rather than eliminate risk through robust resilience planning.

## ***Intervening is not in line with Ofwat's duties to protect customers and enhance resilience***

Ofwat are taking a very precise interpretation of exclusions and whether the specific circumstances are listed in the PR19 Final Determination outcomes definition appendices.

We agree that known and foreseeable impacts of performance that maintain confidence in delivery for customers and the environment by the water sector includes recognition that performance commitments and their definitions do not change during a price control period. However, this does not in itself fulfil the requirement for Ofwat to consider whether adjustments for the specific circumstances support the section 2 duties.

The Draft Determination recognises this, stating “*we have considered South West Water's performance in relation to each relevant PC and whether, in light of our duties and policy objectives, we should exercise our discretion to depart from the outcomes that would ordinarily flow from operation of the ODIs, to make changes to payments.*”

We recognise that Ofwat has considered this as part of considering its finance duty, for instance through considering whether the financial impact falls outside of P10 and P90 levels of RoRE, and the relevance of caps and collars. While this criteria and the presence of caps and collars is relevant, it is not sufficient in terms of considering whether the regulatory judgement linked to the policy objective furthers the delivery of WIA Section 2 duties as a whole. The circumstances here are outside of those envisaged in regulatory incentive design. For this reason, as well as the finance objective/duty, we believe the resilience and consumer objectives deserve further consideration.

For completeness we refer to these duties below:

The resilience objective is “*(a) to secure the long-term resilience of water undertakers' supply systems and sewerage undertakers' sewerage systems as regards environmental pressures, population growth and changes in consumer behaviour, and*

*(b) to secure that undertakers take steps for the purpose of enabling them to meet, in the long term, the need for the supply of water and the provision of sewerage services to consumers, including by promoting—*

- (i) appropriate long-term planning and investment by relevant undertakers, and*
- (ii) the taking by them of a range of measures to manage water resources in sustainable ways, and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources.”*

The consumer objective is “*to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.*”

Taken together, we believe the in-period ODI Draft Determination for this event has some conflict with the duties. We recognise that the consumer objective and resilience objective are furthered (alongside the finance objective) through the outcome framework. However, this is up to the point that application of those incentives would have implications for the sustainability of long-term resilience on water resources, and/or implies investment or operational responses that are not in consumers' interests.

We cannot expect exceptions to ODIs to capture every situation which would not benefit the consumer and resilience duties, although in some ODI definitions this is inherent such as through the way the DWI metrics (water quality contacts, CRI etc) operate through risk-based assessment. This is harder for other ODIs, but an assessment of the long-term impact on the duties is important. It is informative to consider this for the in-period ODIs now, as well as considering as learning points for future ODI designs at PR24.

The implications of not allowing an exception in this situation, where despite the best endeavours of South West Water to both make a third party aware of the location of two strategic mains, and to then intervene when it was apparent that there was a risk of mains damage because of the third party contractor work, should directly relate to the discretion under these duties.

It is not disputed in the Draft Determination that there is existing, effective resilience duplication of this strategic main in the affected location, and only exceptional negligent behaviour by third parties, both in drilling despite the information available to them on the location of the two resilience mains, and then continuing into the second main having damaged the first, triggered the supply interruption and the length of time taken to resolve it. It is also not disputed that South West Water had resources in place to respond to the incident and took all possible actions to minimise the impact on customers.

As set out earlier we do not think it is sufficient in this case to assess the overall performance and level of ODIs, including considering caps and collars and the upside and downside risk from ODIs. In considering whether not intervening would create unwanted incentives to invest so as to minimise risk in an inefficient way, Ofwat states that the mitigation that is available to companies is through base expenditure for normal supply interruptions and enhancement expenditure for low risk / high consequence resilience impacts such as this. We would question whether this was consistent with the resilience and consumer duties. It implies that for this reckless third party event by a utility that has similar legal duties to South West Water, the event could justify a third resilience main. As the location of any such third party action is not predictable, that implies excess resilience investment across an entire water distribution system. As a matter of policy, we question whether the section on “unwanted incentives” and expenditure on page 8 of the in-period ODI Draft Determination should stand.

In this case we have provided evidence that 70% of customers found it unacceptable that customer bills should reflect such a small probability event (in particular because of third party reckless behaviour), even though they support a standard level of duplication for resilience within bills. The consumer objective is therefore also not supported by the suggestion in the Draft Determination that enhancement expenditure could, with customer support, fund such additional resilience. In this case the resilience that is cost beneficial has been considered in the provision of a duplicate strategic main.

As a minimum, we think that as a matter of policy water customers should not fund the potential future resilience risk cost to avoid incentive penalties (the cost/service package) because a third party has behaved so exceptionally. There is an issue of cross-utility consumer policy relevant here as, where water sector performance is being highlighted negatively for consequential impacts of energy sector failures, which could have implications for the finance objective alongside resilience and consumer objectives. There is also an issue with the reputation of the water sector with a description of penalties and fines on the water sector for what is an event that should never happen and could not be avoided by SWW action.

## **Sewer Blockages**

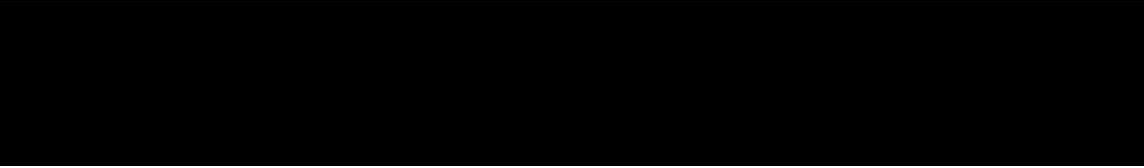
We are disappointed with Ofwat's conclusion. The resilience and consumer duty should not suggest that companies are responsible for the repeated and deliberate misuse of sewers when the Water Industry Act 1991 s.111 sanctions such behaviour. Even if a company is proactive in taking action once this has been identified, the ODI penalty will still apply irrespective of company action.

## **Leakage and per capita consumption**

We note Ofwat's deferment of a decision on the leakage performance commitment and ODI. We believe that sufficient information has been provided to demonstrate that the reported leakage is a real reflection of our performance. We would expect further engagement once Ofwat has assessed the information that has been provided and any further information that you may request.

We do request that Ofwat reconsider the Draft Determination based on the information provided. And if any questions, please do not hesitate to contact.

Yours sincerely



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