



By email only

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Ofwat

Date
27 October 2023

████████████████████
cc: in-periodODIs@ofwat.gov.uk

Request to defer part of the underperformance penalty to AMP8 Or to bring forward the under recovery of revenue to 2024/25

Background

In response to draft determination of the in-period Outcome Delivery Incentives (ODIs) for 2022/23, we have accepted the comments and determination of the ODIs, although we stated we are considering the feasibility of requesting a deferral of a proportion of the ODI underperformance payments for this period.

Our turnaround plan maximises expenditure in the last two years of the current AMP to efficiently deliver a step change in performance and deliver our planned outcomes. This is supported by further equity from our shareholders and the restriction of dividends. We are continuing to experience inflation pressures which means the financial position against our covenants is tight. We expect our covenant ratios to recover in the next AMP.

In the current year we have experienced lower consumption of water by our residential customer than expected when we set the tariffs for the year. We are forecasting a shortfall in revenues for the year of £26m. The shortfall would be recovered in the 2025/26 revenues, leaving the company with lower than expected revenues for AMP7 and higher bills in the first year of AMP8 than we have set out in our PR24 submission. The current year revenue shortfall will put further pressure onto our covenant ratios for the current year and for 2024/25.

We are therefore requesting Ofwat to agree to either a deferral of the underperformance payment of £21.451m in 2017/18 prices, being 50% of the 2022/23 ODI penalty or to bring forward the under recovery 2023/24 revenues of £26m 2022/23 prices.

Reasons for deferral

In 2023/24 we are forecasting an under recovery of ~£26m against our allowances for 2023/24. As per the revenue forecasting incentive model this under recovery would be reconciled in 2025/26 (as part of PR24). To increase headroom on certain financial covenants, which have been tightened owing to continuing inflationary pressures, we are requesting this is reconciled early through the deferral of 50% of 2022/23 ODI penalties. This will ultimately result in Southern Water receiving the revenue expected in its current plan and will leave customer bills in year 1 of AMP8 in line with our PR24 submission whilst reducing the step change in customer bills from the end of AMP7 to the first year of AMP8.

By the end of 2024/25 we aim to have delivered an ambitious turnaround plan which we report quarterly to Ofwat. Increasing our revenues through deferring the ODI penalties will allow us more headroom to help alleviate pressure on financial covenants. There will be no benefit to our shareholders from this deferral and the Board has no plans to declare any plans to take any dividends in AMP7. However, we require strong credit metrics in order to continue delivering our turnaround programme in AMP7. Any deferral in underperformance payments/bring forward in under recovery, would also be excluded from any metrics used to calculate bonuses or other incentives within the company.

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██ We expect to close the AMP with £85m cash and to be undrawn on our revolving credit facility of £350m. The deferral the underperformance penalty/bring forward of the under recovery would improve this cash position by £25m.

We have two main ratios Interest Cover (ICR) and Gearing. Adjusting our reported July reported covenant position for the £26m shortfall in revenue and no recovering in AMP7, the ICR as at March 2025 will be ██████████ and gearing ██████████ as we plan to invest the additional equity in the turnaround plan and running the company. It should be noted that we expect the Gearing to reduce at the start of AMP8, post the midnight adjustments. The deferral of part of the underperformance penalty/bring forward of the under recovery would reduce gearing to ██████████ and improve the ICR to ██████████

The recent equity injection into the company and the restriction of dividends has supported and will continue to support the additional expenditure required to deliver the turnaround plan and accommodate the above inflation increases in costs such as power and chemicals. However, the equity injection does not improve the ICR position as this ratio only considers operating cash against interest payments and is not affected by financing cashflows.

We have published our PR24 business plan for AMP8. In our plan there is a considerable amount of investment needed for AMP8, resulting in a significant increase in bills. The recovery of the shortfall in revenue for the current year will increase customers' bills in the first year of AMP8 by a further 4%. In our plan, Year 1 of AMP8, has the highest bill increase which we have mitigated by reducing revenue by £105m and spreading this over the subsequent years. Our proposal to defer part of the 2022/23 underperformance penalty would result in the deferral being included in the 2025/26 revenues and offsetting the additional increase above our plan. It would increase average customer bills by c.4% in 2024/25 and therefore reduce the step change in bills in the first year of AMP8, smoothing the transition of bills from AMP7 to AMP8.

Why Southern Water is in a unique position

AMP7 has been a challenging period for the company from a financeability perspective, Funds managed by Macquarie Asset Management have injected over £1.6bn of equity into the Southern Water group since September 2021, when they invested in Southern Water. This has put us in a stronger gearing position and has helped us start our turnaround programme.

There are a number of reasons why we are in a unique circumstance in the industry which have contributed to our AMP7 financeability challenges:

1. In 2020/21 and 2021/22 we paid £75m (2017/18 prices) in ODI underperformance penalties. Our 2022/23 ODI is an additional £42.9m (2017/18 prices). As a percentage of RORE this is the lowest in the sector and more than three times the industry median and puts under materially more financial pressure than our peers.
2. As part of our historic environmental failures, we are currently rebating the £123m penalty to our customers. This has reduced revenues annually each year over AMP7.
3. The incentive rates for the industry are not equivalent for each company. Acknowledging the reasons for and Southern Water's acceptance of the asymmetry, for a number of PCs this has disproportionately impacted Southern Water relative to the other water and wastewater companies:
 - Treatment works compliance – our incentive rate is much larger than the industry and having a smaller incentive rate our penalty would be much smaller.
 - CRI – We have a multiplier on our CRI score due to being under notice. This is not consistent with the rest of the industry. If we did not have the multiplier our penalty would be much lower.
 - Mains repairs - our incentive rate is much larger than the industry. Having a smaller incentive rate would mean our penalty would be much smaller.
 - Voids – We delivered our best ever performance in 2022/23 of 2.82% but we received a penalty of -£0.6m. In contrast, United Utilities delivered 4.45% and received a reward of £8.2m.

We appreciate and support the work Ofwat have done on consolidating ODIs and targets as part of PR24 and understand this cannot be changed mid-Amp for AMP7. We are not disagreeing with the draft determination of our in-period ODIs but the context of our unique position, should, we believe, help inform your decision.

4. 90% of our household customers are metered and therefore we are more susceptible to unexpected changes in consumption and thus revenue recovery is impacted.

Customer impact and consideration

Customers want to see improvements now.

Customers want to see improvements from Southern Water now, not delayed to the future. Past performance and increased scrutiny mean they want to see focus on the areas that matter most to

them, especially environmental performance. [SRN03 Customer Acceptability, Section 3.3.3. Foundational Insight - Common Themes (page 63) Also SRN14 Customer Insight Technical Annex, section 4.1 (page 71 onwards)]

There is a cost-of-living crisis and customers want to keep bills as low as possible. However, they also want investment now rather than push the impact to future generations. [SRN03 Customer Acceptability, Section 3.3.1 Changing Customer Expectations and Influencing Trends (page 62 onwards)]

When reconvening customers who took part in the acceptability testing and sharing the turnaround plan – we see increased support. This is because customers understand that action is being taken now to address underperformance, and this is fundamentally what they want to see. [SRN03 Customer Acceptability, Section 3.2.5.2. Bespoke research programmes focused on key areas, number 6 Acceptability and Affordability Testing (page 55)]

Despite this significant worry about finances, more customers support more immediate bill increases, rather than putting off investment in these important issues. Customers want the investment funded via increases starting sooner and spreading across different generations of bill payers. [SRN03 Customer Acceptability, section 3.4 Feedback on our proposed plan (page 72) and [SRN03 Customer Acceptability, Section 3.3.3. Foundational Insight - Common Themes (page 63) and SRN14 Customer Insight Technical Annex, section 4.1 (page 71 onwards)]

Therefore, any risk to a delay in our turnaround plan would not be in customers' interest.

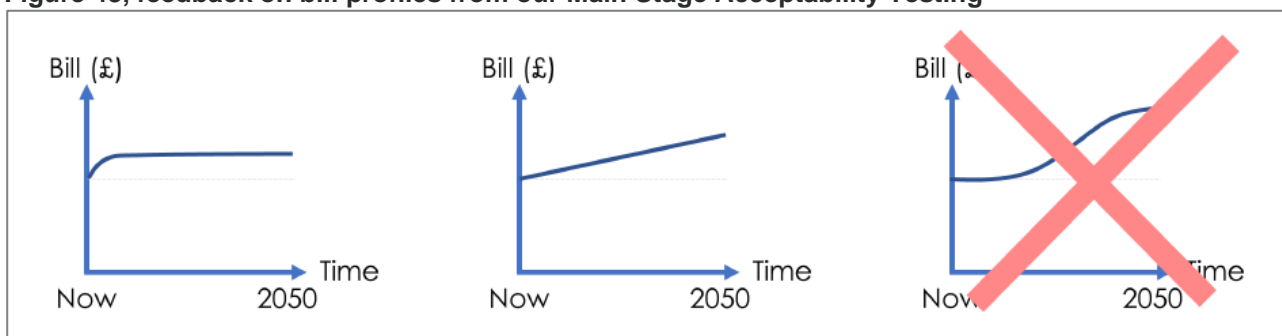
Customers want an improved service and welcome bill reductions especially during a cost-of-living crisis but do not want this to the detriment of a worsening service. [SRN14 Customer Insight Technical Annex, Index - 200q - Southern Water - Water Futures 2030 - Jan '23]

There is a preference to smooth bill profiles.

All customers prefer smooth bills as opposed to bill volatility. In particular, businesses want stability to allow for budgeting and planning. [SRN14 Customer Insight Technical Annex, Section 4.5 (page 87 onwards)]

Whilst ODI's can be confusing to customers, once informed they understand and support their use. However, we see that understanding the impact of bills being spread over time pleasantly surprises customers. [SRN14 Customer Insight Technical Annex, Index - 200q - Southern Water - Water Futures 2030 - Jan '23]

Figure 43, feedback on bill profiles from our Main Stage Acceptability Testing



Customers prefer a smoother increase. Some customers (e.g. larger businesses) prefer a jump in the short term they call a 'reset' while others (e.g. lower income) would rather keep bills as low for as long as possible to help with the current crisis. [SRN14 Customer Insight Technical Annex, Section 4.5 (page 87 onwards)]

Over the period between now and 2030 customers will not be worse off in the event of a deferral of our underperformance payment. The bills will still take into account all of the ODI payments for the year 2022/23 but at a later date and with a greater certainty that we will be able to deliver our turnaround plan. It is clear from our customer research that customers value the improvements in our service more than reductions in their bills.

We have discussed the consideration of deferring a proportion of our ODI payments with CCW and they agree on the benefit of a smoother bill transition into AMP8. We have requested a meeting with CCW in the coming weeks to further discuss this request.

Our proposed split

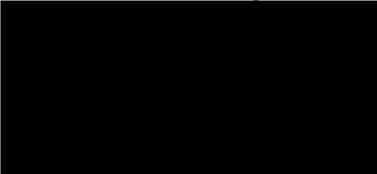
Set out below is the proposed split of the deferral across price controls. All figures are in 2017/18 prices:

Price control	DD ODI payments to be applied to customer bills in 2024- 25 (£m)	SRN request ODI payments to be applied to customer bills in 2024- 25 (£m)
Water resources	-0.958	-0.479
Water network plus	-15.193	-7.596
Wastewater network plus	-21.209	-10.604
Bioresources	-1.286	-0.643
Residential retail	-4.257	-2.128
Total	-42.903	-21.451

We have proposed to reduce the ODI underperformance payments equally as per each price control.

We look forward to hearing your decision.

Yours sincerely,


Stuart Ledger
Chief Financial Officer