

Drainage and Wastewater Management Plan

Water company funding webinar – your questions answered

December 2021



from
**Southern
Water** 

DWMP Water Company Funding Webinar: Your questions answered

The following questions were posted in the chat box during the two water company funding webinars held on 01 and 06 December 2021. We hope our responses provide a full answer to your queries.

1. Following Southern Water's recent fine - what happens to that money? If the fine was for not meeting requirements, how can that lack of funding help increase performance?

Southern Water's Environment Agency fine of £90m received in July 2021 had to be paid directly to HM Treasury. Therefore, it was left up to government to decide how this money should be spent. The £126m fine that was received prior to this by Ofwat resulted in a reduction in wastewater customer bills between 2020 to 2025. All of these fines were paid for by Southern Water shareholders. None of these fines, now or in the future, will be paid for by customers.

As noted in the briefing note from Keith Lough, Southern Water Chair at the time of the July 2021 fine: Southern Water are investing heavily in trying to right the wrongs of the past and significant investment is being put into the business to turn performance around (<https://www.southernwater.co.uk/water-for-life/protecting-the-environment/ea-case-chairman-letter>). Southern Water are on a journey of culture change and transformation and have been since 2017. With investment being increased to resolve these historic issues, we expect performance to improve significantly in key areas over the next few years. We know there is still a long way to go to fully rebuild the trust of all our customers and stakeholders and the only way to build this trust is to show that in our improved performance.

2. Given the DWMP is a new process, will the activities it identifies be funded via an increase in bills or through existing QBEG¹ allocations i.e. are we planning to propose an increase in bills to fund DWMP activity?

As part of the business planning process, we will need to look at all of the needs and requirements impacting our business in the short to long term. The DWMP process will undoubtedly highlight risks that need to be addressed. If these risks require an enhancement of our current operation then we will need to state the case, with customer and stakeholder support, for the cost and solution put forward. Some of the DWMP investment requirements may be identified as base maintenance requirements and funding for this will be assessed as part of Ofwat's base model funding allowance.

Whether water bills increase or decrease will depend on a number of different factors, but will generally relate to the overall size and scale of the investment requirements put forward in our plans (relative to the previous Final Determination). In broad terms though, if we have a relatively largescale enhancement investment programme, greater than the PR19 final determination enhancement, we might expect that bills need to increase. If, for example, we have a more expensive DWMP related investment programme compared to PR19 and a more expensive WINEP programme too, combined this might cause bills to rise. Conversely if the investment programmes are a lower cost we might expect bills to stay neutral or be reduced.

3. Penalties are returned to customers in their "next" bills is "next" the forthcoming year or the forthcoming/next AMP?

It all depends on the Outcome Delivery Incentive (ODI) agreed at the Final Determination stage. Most penalties will be adjusted 'in-period' so, customer water bills will go down in the next bill once the penalty has been confirmed (bills in the period 2020 to 2025 will be impacted). It is noted that penalties/rewards identified at the end of 2020/21 will not impact bills until 2022/23. This is down to the need to verify bill changes with Ofwat and this takes a year to flow through to the final bill.

There are some Outcome Delivery Incentives where the penalties/rewards get assessed at the end of the determination period. These penalties / rewards will impact the next 5 year bills (so would impact bills 2025-2030).

4. With a 5 year business plan, how do you look more long term, particularly with larger scale infrastructure that needs upgrading or provided in light of local plan growth timescales?

Ofwat have made it clear in their consultation papers on PR24 that they want to see 5 year plans set in a longer term context. This is not necessarily a new thing for water companies but is a much supported shift in context for the next Price Review to ensure longer term issues, such as climate change and population growth, are not being left for future generations to pay for.

The Water Resources Management Plan (WRMP) process over the last decade or so, for example, has shown how long-term planning can identify much needed investment in supply (infrastructure) and demand (non-infrastructure) solutions in the short term to tackle micro and macro issues for the long-term. Water companies will be required to broaden their longer-term plans beyond DWMPs and WRMPs to ensure that all parts of their plans understand long term impacts and investment needs.

5. What projects are going to take priority now that we have this new investment?

From a Southern Water point of view, our current investment programme is looking to drive improved environmental and customer outcomes. We have a strategic plan that requires us to be 'brilliant at the basics' but is also striving to be 'transformational' in the future to ensure a 'resilient water future for the South East'. With our PR24 business plan there will certainly still need to be investment prioritisation discussions as we cannot do everything everybody wants; it would just be too expensive. Therefore, we will be looking for customer and stakeholder views over the coming months to determine where they believe the highest priorities are for us to invest in and which projects should be promoted for implementation. We will also be looking for partnership and collaboration opportunities to find solutions that provide greater environmental and social value. We will welcome people's support wherever possible on this prioritisation piece.

6. There are plenty of other investment needs. It is disingenuous to suggest that it is only environmental improvements which drive investment and prices.

We completely agree, it was never the intention to make it seem like the environment is the only driver of investment and costs. There are lots of factors that will drive investment and costs. The environmental improvements are a big-ticket item, but there are lots of other drivers for investment

such as good customer service, vulnerable customer support, managing water quality risks and cyber security.

7. Great targets, have you got details on how you are going to achieve these?

Our PR19 business plan articulated how we intend to achieve many of our goals and targets at that moment in time. The PR24 business plan will provide an update on this and look to address any new targets that may have been committed to since PR19. This is exactly what the business plans are for. We need to clearly articulate how we intend to deliver on our promises, outcomes and goals between now and the target deadline.

8. On experiences of delays with SW delivery of water infrastructure on development sites creating a challenge for the delivery of homes: how are developers and landowners factored into the customer service model?

Southern Water are working very hard to address developer and landowner concerns. Highlighted by the fact that we are holding industry leading engagement events, such as the developer services event at Brighton Amex Stadium held in late 2021. We want to understand and address the developer concerns raised and we are doing everything we can in this space to support and improve our service delivery where possible. If you are having problems, please do not hesitate to constructively engage with us on these issues.

Customer service for developers is factored into the D-Mex performance commitment. Failure to address developer concerns will result in underperformance against this key metric and results in penalties. So, it does remain a key factor in our customer service model for the whole sector.

9. What would your advice be to Catchment Partnerships and customers to help them influence bodies such as Consumer Council for Water (CCWater) / Ofwat to have regard to stakeholder views that environment and natural capital requires greater support in their strategies and decisions in the short and long term? Presumably changes there would assist some of the challenges you have outlined?

First and foremost, we hope Catchment Partnerships, stakeholder groups and customers will support the development of our PR24 plans, especially in the next 9 to 12 months. The DWMP, for example, will be consulting on its proposals in 2022 and this will need all groups to review and provide feedback. We want Catchment Partnerships, stakeholders and customers to review, suggest alterations and ultimately, to support our proposed plans being put forward.

Influencing and showing support for water company proposals will be the biggest and best way to influence bodies such as CWater and Ofwat.

In terms of influencing CWater / Ofwat more directly, we would suggest responding, where appropriate, to any consultation documents that are launched by these organisations. Ofwat, for example, will be consulting on their draft methodology for PR24 in the Summer of 2022 and this should allow for stakeholders to provide their views on the process.

10. If OFWAT do not 'Regulate / Enforce the Environment' and much of the performance and impact falls to the likes of the EA, Defra and NE, who picks up this accountability in performance, penalties and future adequate financing in future?

Through outcome delivery incentives (penalty / rewards), Ofwat regulates / enforces environmental performance. The EA / Defra are required to enforce where there are legal / criminal problems identified. As shown in slide 6, Ofwat has the clear duty to ensure that Water Companies meet their statutory / regulatory environmental duties and it has the job of ensuring there is adequate financing for this. This is why Ofwat assess business plans every 5 years to ensure these duties are being met in the short to long term.

Having said this though, it is ultimately down to water companies to be accountable for delivering their statutory and regulatory duties for customer and the environment. Ofwat, EA and Defra all regulate the water industry to ensure this happens.

11. Is there an expectation there will be another Interim Assessment of Plans (IAP) process for PR24

In Ofwat's high level consultation paper (May 2021), it consulted on the concept of potentially removing this interim step. Ofwat has not yet made it clear as to whether this interim assessment step will be kept, be removed or evolve into something else. The Ofwat PR24 methodology consultation in summer 2022 is likely to highlight its intentions in terms of the PR24 process. The interim assessment stage has previously been useful for water companies to understand how their plans are being received by Ofwat prior to the draft and final determination stages. This process step has allowed companies the opportunity to adjust their plans, where appropriate, ahead of the final Ofwat decision stages.

12. How will projects be prioritised if funding for improvements is basically rationed because the overall settlement is insufficient?

If the overall funding settlement is insufficient, water companies will have difficult choices to make. However, the first thing companies will be doing is to find opportunities and ways to operate more efficiently - effectively deliver the same projects with the same level of performance benefits but deliver them more cost effectively. This is something water companies will always be looking to do and this will not impact prioritisation but it does put a challenge on the business to seek more cost effective ways to implement solutions.

If the company believes it is operating as efficiently as possible, it is at this point that further prioritisation decisions need to be made. Again, we will base these decisions on previous customer and stakeholder priority assessments. After delivering health & safety and essential services to customers, what customers and stakeholders' value more will be prioritised first. Hence, the reiteration of the importance for customer and stakeholders to continue to engage with water companies to influence our priorities now and into the future.

13. There's been a lot of concern about increasing debt levels within water companies. Could you explain how water companies take on debt, and how Ofwat regulate that (i.e. do they monitor debt limits or where the borrowed money is used - for infrastructure development rather than investor servicing?). Why did Southern Water allow high levels of debt to accumulate and how much are the annual interest

payments? Surely this is now hampering investment in infrastructure and/or raising customer bills.

We have very significant capital investment requirements to maintain our asset base and deliver environmental, drinking water and customer service improvements. If all of this investment was funded on a 'pay-as-you-go' basis, customer bills would become affordable. So, the regulatory system works on the assumption that capital investment will be financed through debt and shareholders' funds, allowing for the costs to be spread over the lifetime of the investments and keeping bills affordable for customers.

Like all water companies, Southern Water issues debt in the form of bonds on the capital markets. When Ofwat sets price limits each five years, it makes an allowance for the costs of interest on debt and for a reasonable return to shareholders, based on the market return for similar investments and an efficient financial structure. Ofwat does not directly regulate the level of debt that companies take on (or indeed the level of dividends), but it closely monitors companies' financial resilience and requires all companies to demonstrate that their financial structures are resilient through stress testing and the provision of a Long-Term Viability Statement each year. Ofwat also introduced a specific incentive mechanism at the last Price Review which effectively penalised companies with debt levels that represented more than 70% of their capital value. Southern Water has debt levels that are below Ofwat's 70% threshold and the recent change of ownership and associated injection of shareholder funds into the business has improved our financial resilience and put us in a good position to fund our investment programme going forward. Our new shareholders have also provided funds for additional investment of £230m over and above the levels allowed for by Ofwat when they set price limits at PR19.

14. Surely its more cost effective to invest in the infrastructure rather than paying clean-up costs - and far better reputationally?

We completely agree, not just regarding the cost of clean-up but the reputational damage / trust impact is significant if we do not adequately invest in the right infrastructure and non-infrastructure solutions to address problems in future.

15. How will the DWWMP also align with the emerging WRMP options coming through WRSE Regional planning?

We are working with our colleagues developing the Water Resources Management Plan (WRMP) so we can align options where there are links and dependencies. Water Resources South East (WRSE), for example, are considering strategic resource options such as water recycling from wastewater treatment works - which may reduce discharges to the sea.

16. What level of detail of water company finances and Ofwat reporting/planning are publicly available?

All of Southern Water detailed financial statements and annual performance reports are published annually on our company website (<https://www.southernwater.co.uk/our-performance/reports>). We also publish all of our business plan data on our website.

Ofwat also makes all of the business plan determination documents available on their website and publish annual performance report data publicly (<https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/>).

Therefore, all of our financial and reporting data, with redactions only where data is of national security concern, are transparently reported by us and our regulators publicly.

17. Are there many appeals (against the Final Determination)?

Historically, there are very few appeals by water companies to Ofwat's Final Determinations. There are many reasons for this being the case. With 4 appeals, the PR19 Final Determination did receive a high number of appeals. The companies that appealed included Anglian Water, Northumbrian Water, Yorkshire Water and Bristol Water.

These appeals were broadly successful in terms of those companies receiving additional allowances to deliver their plans. However, none of the companies that appealed were awarded all of the investment they originally required in their business plans.

More details about these appeals can be found on the Ofwat website (<https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/regulated-companies-price-review-2019-price-review-competition-and-markets-authority-referrals/>).

18. Does Ofwat consult with water companies before issuing Final Determinations?

Ofwat does consult with water companies throughout the Price Review process (see also slide 17). The process is summarised as follows:

- 1) Ofwat provides high level PR24 views and papers for discussion and consultation. We are in this phase now and water companies / stakeholders are providing their views on various papers being issued by Ofwat.
- 2) Ofwat issues their PR24 methodology for consultation. Ofwat will be outlining its PR24 expectations and method for assessing plans. Companies and stakeholders are consulted at this stage and have the opportunity to respond to the proposals being put forward.
- 3) Ofwat provides a PR24 final methodology that tells water companies what the final process and method for PR24 will be (no consultation).
- 4) Water companies submit their customer and stakeholder supported final business plans to Ofwat.
- 5) Ofwat assesses these plans and provides an interim assessment of the plans for companies to provide comment, extra evidence and updates on (noted this stage might be removed for PR24).
- 6) Ofwat assesses the plans and provides a draft determination decision that water companies will respond to. This is the last chance for water companies to make their case for their business plan and funding allowances.
- 7) Ofwat assesses the plans and provide a final determination decision that water companies have to accept in full or take to appeal via the Competition and Market Authority (CMA)

Water companies, particularly prior to final business plan submission, will consult with Ofwat and all its regulators to ensure the plans being developed are meeting regulator expectations as much as possible.

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ⁱ QBEG = Quality (enhancement related to improving river or water quality), Base (Base maintenance and operating costs), Enhanced levels of service (enhancing service levels beyond the base current levels of service – in more recent times this relates to beyond upper quartile performance enhancement such as Bathing Waters to Excellent) and Growth (enhancing services to meet growth requirements). In the past, Ofwat split investment into these categories. In more recent times, Ofwat has moved away from these classifications but they still exist and QBEG is used when grouping certain investment types together.