Response to Draft Determination

Revenue correction mechanism: back-billing adjustment

Issue

In our June business plan update we included a Revenue Correction Mechanism (RCM) case, based on a revenue shortfall of £217m over AMP5. We explained that the largest element of this shortfall, £127m (60%), related to ‘known’ issues, identified and discussed with Ofwat in the later stages of PR09. Of the remaining £90m, £38m related solely to differences between Ofwat’s PR09 inflation forecasts and the actual values.

The remaining £52m was attributable to issues such as lower consumption, property growth, and the impact of our Universal Metering Programme. This genuine in-period variance was equivalent to 1.4% of total revenues. We would note this is within Ofwat’s forecast tolerance for the new Wholesale Revenue Forecasting Mechanism which is applied to forecasts made just a year in advance. In the draft determination Ofwat has not raised any further queries in respect of the main part of our RCM case or asked for further information.

However, our revenue recovery initiatives, which were part of our mitigation of the shortfall in AMP5, gave rise to a claim of £11.550m associated with the back-billing incentive part of the RCM. Ofwat has not included the back-billed amounts in the draft determination assumption. This is because of concerns over whether the back-billed amounts being claimed are compliant with the guidance set out in RAG4.04 and IN11/04. Specifically, Ofwat suggest that:

“The company has not demonstrated that:

- it has claimed for the back-billed amounts where the inaccuracy of the charging is the customer’s fault; and
- it has taken a reasonable, fair and appropriate approach for the back-billed amounts claimed.”

Ofwat’s comment that we have not demonstrated that the inaccuracy of the charging is “the customer’s fault” is not in line with the test set out in IN11/04 which requires that we do not make a claim where “not to claim for back-billed amounts where the inaccuracy of the charging is the company’s fault”. This is a materially different burden of proof than that cited in the Draft Determination.

Since receipt of the draft determination we have reviewed all of the 3,209 cases that made up our back-billing claim to verify where the fault, if any, lay. This analysis has been independently assured by Halcrow Management Sciences Ltd.
On the basis of that review, we have excluded from our claim any cases where there is clear evidence of company fault, in line with the policy set out in IN11/04 and cases where there is insufficient evidence. This has reduced the back-billing claim from £11.550m to £10.040m. We have reflected this in an updated version of the RCM feeder model, which is included with this response.

Ofwat has not made clear in its Draft Determination how it expects companies to demonstrate that they have taken a “reasonable, fair and appropriate” approach to the back-billed amounts claimed”. We believe our claim is consistent with the methodology. However, we note that no forecast of back-billing has been made for 2013-14 and 2014-15, although we are continuing with this activity.

Remedy

In the final determination we believe Ofwat should:

- Allow that part of the back-billing claim where the inaccuracy of the charging is not the company’s fault, as set out in this response.
Summary of the evidence

1. Justification

Following the draft determination we have reviewed all of the 3,209 back-billing cases claimed within the RCM. These have been classified into the following groups, based on the categorisation rules set out in Annex 1.

(i) Customer fault
(ii) Water only company fault i.e. WoC meter asset has under read
(iii) Customer failure to notify SWS of an error they should have been aware of
(iv) SWS fault
(v) Insufficient evidence

The results of this classification exercise are presented below. On the basis of this new evidence, we believe Ofwat should allow that part of the back-billing claim included in this representation, consistent with the clear policy set out in IN11/04.

2. Evidence

Our back-billing claim was based on 3,209 cases, with a total value of £8.536m. When the relevant multipliers are applied through the RCM feeder model, this equates to a total back-billing claim £11.550m, all of which has been disallowed.

In response to the feedback provided in the final determination we have carried out a detailed classification exercise, examining the files for all 3,209 back-billing cases. The results of this review are set out in Table 1 below. [An Excel spreadsheet with details of all of the cases examined is included with this submission.]

Table 1. Classification of back-billing cases reviewed

<table>
<thead>
<tr>
<th>No. of cases</th>
<th>Value of claim (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Customer fault</td>
<td>376</td>
</tr>
<tr>
<td>(ii) WoC fault</td>
<td>187</td>
</tr>
<tr>
<td>(iii) Customer failure to notify SWS of error</td>
<td>2379</td>
</tr>
<tr>
<td>(iv) SW fault</td>
<td>126</td>
</tr>
<tr>
<td>(v) Insufficient evidence</td>
<td>141</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>3209</strong></td>
</tr>
</tbody>
</table>
We have updated our claim to exclude those cases where the fault was ours or where there is insufficient evidence to understand who was at fault. We have included cases where the customer failed to notify us of an error which they should have been aware of.

Examples include where a waste connection has been notified but the customer has never received a wastewater bill. We believe this is consistent with the intention of the guidance in IN11/04.

As we set out in our December business plan we have only included cases where we have recovered all amounts billed. This is in line with the requirements in RAG4.04 that we should only include cases where the customer has been billed and we “have received all outstanding amounts due from the customer”. Ofwat has not challenged this aspect of our claim in its Draft Determination.

We have updated the back-billing claim within the Ofwat feeder model, based on these revised amounts. The result is a reduction in our back-billing claim from £11.550m to £10.040m.

3. Board Engagement

The Board has reviewed the approach taken to updating the back-billing element of the RCM claim. It has also reviewed the findings of the assurance exercise (see below). On the basis of that review, the Board has confirmed that it supports the claim set out in this representation.

4. CCG

As an AMP5 legacy mechanism, the operation of the RCM is outside of the scope of the CCG. As set out in our June business plan update, the CCG has been briefed on the causes and impact of the revenue shortfall.

5. External Assurance

To provide independent assurance that the classification exercise has been carried out appropriately, and in line with the requirements of IN11/04 and RAG4.04, we asked Halcrow Management Sciences Ltd (our former Ofwat Reporter) to carry out a review of the approach to the classification exercise and an audit of the findings. A copy of Halcrow’s opinion is attached at Annex 2. They concluded that sample checks showed that that the Company’s methodology for the assessment of back-billing scenarios and the fault that caused them is reasonable, and that that the methodology has been consistently applied. The audit sample checks confirmed the robustness of the evidence base for the results obtained.
6. Annexes

Annex 1. Definitions for criteria used for the classification exercise

Supporting spreadsheets:
(a) Full results of the classification exercise
(b) Updated RCM feeder model
Annex 1 – Definitions for criteria used for the classification exercise

Background

Southern Water needs to investigate all 3,209 instances of successful back-billing made between 2010 and 2013 to establish the reason why charges were originally incorrect, for use in the submission to the draft determination response.

Overview of process

1. Each individual case needs to be looked at independently.
2. Any appropriate archived notes and documents from all relevant systems need to be reviewed to ensure that we make the best-informed judgment.
3. An unbiased judgment needs to be made on why charges were originally incorrect or missing.
4. One of the following six high level reasons should be chosen:
   a. Customer fault
   b. WoC fault
   c. WoC fault originally, but customer should be aware
   d. Southern Water fault originally, but customer should have been aware they were being under-billed
   e. Southern Water fault
   f. Unable to find archived/insufficient evidence
5. A list of common scenarios is provided to ensure consistent classification
6. The name (initials) of the person who has reviewed the case should be entered against the record on the spreadsheet.

Guidance on use of high level fault reasons

The table below sets out a number of common back-billing scenarios, and provides guidance on assigning a high level fault reason.

However, each case should be considered on its own merits. Where there is evidence to support it, a different fault reason should be used to that suggested in the table. A note to this effect should be included in the descriptive narrative.

Table 1: Common scenarios with standard fault codes

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Notes – If non-standard</th>
<th>Fault Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stopped Meter SW</td>
<td></td>
<td>SW fault originally but customer should be aware</td>
</tr>
<tr>
<td>Stopped Meter WOC</td>
<td></td>
<td>WOC fault originally but customer should be aware</td>
</tr>
<tr>
<td>Void SW &amp; WOC</td>
<td></td>
<td>Customer Fault</td>
</tr>
<tr>
<td>Missed Waste – with notification to SW for new</td>
<td></td>
<td>SW fault originally but customer should be aware</td>
</tr>
<tr>
<td>Connection</td>
<td>Fault Code</td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Missed Waste – <strong>without</strong> notification to SW for new connection</td>
<td>Customer Fault</td>
<td></td>
</tr>
<tr>
<td>Missed supply SW</td>
<td>SW fault originally but customer should be aware</td>
<td></td>
</tr>
<tr>
<td>Missed supply WOC not billing</td>
<td>WOC fault originally but customer should be aware</td>
<td></td>
</tr>
<tr>
<td>Missed supply WOC were billing</td>
<td>SW fault originally but customer should be aware</td>
<td></td>
</tr>
<tr>
<td>SW Transposed Meters, Incorrect meter size or incorrect number of dials, underestimated reads</td>
<td>SW Fault</td>
<td></td>
</tr>
<tr>
<td>WOC Transposed Meters, Incorrect meter size or incorrect number of dials, underestimated reads</td>
<td>WOC Fault</td>
<td></td>
</tr>
<tr>
<td>Incorrect rate category – including Trade Effluent</td>
<td>SW fault originally but customer should be aware</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>Outside common scenarios or fault different from standard code – Agent assigns fault code with accompanying notes</td>
<td></td>
</tr>
</tbody>
</table>

**Notes**

Voids – Property all set up as chargeable on billing system, awaiting occupier

Missed Waste – Waste service not on billing system

Missed Supply - Metered or unmetered supply not set up for billing

Other - Ask yourself the question: Should SW have known the charge was missing? Should the customer have known the charge was missing? Ensure notes column populated with individual scenario and set Fault Code

Unable to find archived/insufficient evidence - should be used when applicable