



Executive Summary

We are pleased to provide Southern Water's response to Ofwat's Draft Determination.

We have welcomed Ofwat's collaborative approach in reaching its conclusions to date and look forward to this continuing as we move towards conclusion of the price review process. While Ofwat has recognised many strengths in our evolving plan, we consider there to be a number of significant challenges in the Draft Determination that still need to be discussed and addressed in order for us to be confident that we can deliver our business plan and commitments to customers. In this response to the DD, our Board has been clear that our response should focus on the most material issues having bearing on our customers' portfolio of preferences and the integrity of the package as a whole.

In addition to delivering our commitments in AMP6, AMP7 and beyond, there is ongoing work that we are doing to address historical performance issues and this is continuing to gain traction. We have come a long way in operational efficiency improvements through our company-wide transformation programme, particularly our approach to integrated business planning, operationalising our performance improvement and incident management action plans and we have now developed our plans to improve our long term resilience. We have done a lot already in identifying the key areas for improvement and the corresponding, ambitious efficiencies that we can make. These were fully factored into our response to the Initial Assessment of Plans (IAP).

In our response to Ofwat's IAP, we developed a comprehensive, constructive submission addressing all actions. We reduced totex funding by c.£360m, presented new evidence to support the remaining c.£400m and accepted greater challenge on the majority of our ODIs. Our level of cost efficiency shifted substantially, and notably by a significant proportion compared to the rest of the industry. We also accepted further stretch in target performance. Taking all of this into account, we believe that a further shift in our cost allowances would put undue pressure on our ability to effectively execute our plan.

We were pleased that Ofwat acknowledged that our plan is strong in some areas, particularly in retail and affordability and vulnerability, and noting our comprehensive IAP submission, accepted our responses to a large number of the actions that we provided additional evidence to support. There are some remaining material challenges within our DD where we have strong evidence to support adjustments in the FD. Our focus in providing new and strengthened evidence has been on eight key cases relating largely to our cost allowances, outcomes and financeability. We have also set out a number of other cases where we believe improvements/amendments to Ofwat's modelling or method should be made.

There remains a cost gap of c.£304m in our draft determination. We have accepted c.£42m of cost reduction relating to activities such as WRMP and catchment management and CAC disallowances. Through our representations, we are challenging the remaining c.£262m of the cost gap, based on additional and strengthened evidence.

As noted, our Board has been clear that we should focus on only the key issues in the Draft Determination. We have set out below the material representations where we present new evidence to support our view that we are currently underfunded in a number of areas to deliver our AMP7 plan with the level of performance stretch implicit within it.

1. Cost efficiency in water and wastewater

1.1. Cost allowances for growth

In the Draft Determination, Ofwat has changed the way it makes allowances for growth by including it in the botex models for water and wastewater. By including growth in base costs but without including any growth-specific cost drivers, this approach does not accurately allow for costs related to growth. Further, it has not included appropriate forecasts of cost drivers nor taken account of the level of expenditure required to manage future growth. The consequence of the revised modelling approach is a material underfunding of our growth costs by £137m. We propose that Ofwat uses the data it has collected since the IAP on company growth costs to model company-specific growth allowances on an accurate and comparable basis. We also believe there is merit in working collaboratively with industry to do this and we would welcome this opportunity.

1.2. Cost allowances for raw water deterioration

We believe the Draft Determination does not allow for sufficient expenditure to address raw water deterioration in our region. Ofwat has based the botex models on flat treatment complexity forecasts, based on historical data, rather than on our submitted treatment complexity forecasts, thereby not accurately reflecting our treatment complexity. This method is contrary to the adjustments accepted on other cost drivers. As a result of this approach, our totex allowance is £10.6m lower than is required to improve raw water deterioration. We suggest that our treatment complexity forecasts are included in the botex models to allow for expenditure required to address raw water deterioration.

1.3. Funding of upper quartile leakage targets

Ofwat is not proposing to provide additional funding for reaching upper quartile targets in leakage reduction and, at the IAP, noted that funding for leakage reduction was already included in the botex models based on the rationale that leakage reductions have been delivered in the past. The costs included in Ofwat's models are costs associated with leakage reduction in the past and, as Ofwat state, leakage reduction has been relatively flat across the sector for the last 20 years. Therefore, as leakage reduces, the marginal cost of further reductions increases as further investment is required. By imposing an effective regulatory requirement on companies to reduce leakage by at least 15%, while disallowing costs which an efficient company would expect to incur, Ofwat is arguably failing to meet its statutory duties to allow an efficiently run company to finance its functions, which for Southern Water is c.£33m in AMP7. Our proposal is that Ofwat allows additional funding for activities to reduce leakage that are incremental on that delivered in AMP6.

1.4. Ofwat approach to environmental obligations

Ofwat has changed its approach to determining a totex allowance for expenditure relating to environmental obligations to now assess costs at the programme level e.g. WINEP, and subsequently apply an industry wide efficiency challenge of 9%. We believe that the application of a 9% forward-looking efficiency challenge doesn't take into account the significant efficiency stretch we have already included in our view of enhancement costs. This underestimates the required totex for enhancement programmes by £50m and gives an efficiency challenge at a level more stringent than the upper quartile. We suggest that the 9% efficiency challenge is removed to avoid double counting of the efficiency stretch already accounted for in our WINEP programme.

2. Outcomes

2.1. Compliance Risk Index (CRI) ODI deadbands

Ofwat has proposed an industry-wide target for CRI which does not take into account the variability of risk between different regions and different companies. This approach puts undue weight on the impact of failures at our Testwood treatment works which would trigger an immediate penalty payment. Our view is that our performance at Testwood should be considered separately to the CRI performance at our other facilities to continue to incentivise good performance at those other facilities, and to enable us to deliver our improvement plans at Testwood already accepted by the DWI. The challenging deadband level set by Ofwat could result in an underperformance payment, even if the Testwood improvement schedule, agreed with the DWI, is fully met. We propose an approach that would allow for a company specific adjustment to Southern Water's CRI deadband which takes account of these circumstances and incentivises us to deliver continuous improvements at our other facilities.

2.2. ODI Collars

Ofwat has retained the use of collars for financially significant ODIs, in line with its guidance at the IAP. However, the approach to calculating the level at which the collar is set has changed significantly. Collars have now been set at a multiple of the performance commitment level, relative to the first year target. This approach is not aligned with the previously published policy objectives and the new approach is not sufficiently transparent. The new, proposed collar levels would result in our maximum underperformance payments increasing by £192m over AMP7. This approach encourages a focus on penalty-avoidance, and incentivises in a way that is inconsistent with our customers' preferences. Our proposed solution is for the approach to return to that established in policy at the IAP, which is to set collars for financially significant ODIs at the P10 level proposed by the company.

3. Financeability and other cases

3.1. Financeability in the round

We believe we will be able to raise necessary finance as and when required to support our Business Plan (including our Draft Determination representations) on the basis of both a notional as well as actual financial structure at a target credit rating of Baa2.

The Baa2 credit rating is below the target credit rating of Baa1 that underpinned our IAP response. We do not believe a target credit rating of Baa1 is achievable under the notional structure absent an increase in the allowed cost of capital.

In the absence of material movement in the regulatory determination between Draft Determination and Final Determination, we would need to reassess financeability on the basis of the balance of risk given the stretching targets that have been set in relation to cost efficiency and performance commitments.

Any further reductions in the WACC would cast the financing of our plan into doubt and would require extensive re-assessment of both our ability to raise debt, and our financial headroom.

3.2. Funding of schemes subject to DPC market testing

Ofwat has provided an efficient level of funding for development of strategic regional water resource options, including de-salination and alternatives, a transfer from Thames and transfers from Wessex and Southwest Water. We welcome this aspect of the draft determination. Ofwat has also recognised our need for early decision gates, due to our Section 20 agreement with the Environment Agency that requires us to deliver long-term solutions to the supply-demand deficit in Hampshire by 2027. Ofwat has also proposed an uncertainty mechanism that would apply in the event that a value for money assessment supported a decision to move from a DPC approach to a traditional in-house delivery process. We have concerns with this proposal as we believe that it is not reasonable for Southern Water to bear the risk of the additional costs that would fall on it during AMP7 in the event that a value for money assessment concludes that it would no longer be cost effective to proceed by way of a DPC. We propose an alternative approach similar to the uncertainty mechanism derived from the WINEP uncertainty mechanism. This mechanism would be based on unit costs for particular solutions, where a cost driver is known in advance but the need for the scheme and its scale maybe uncertain. If, on the other hand, a DPC value for money assessment concludes that the project should be constructed by Southern Water on a traditional in-house delivery basis, we propose a gated process whereby PR24 would enable Ofwat to assess the efficient level of costs incurred to date relative to the unit costs set out at Gate 4.

3.3. Other cases

In addition to the key representations set out above, we have also provided a series of responses addressing less material issues. These responses address areas where we believe that there are inconsistencies or errors in models and assumptions, our evidence may have been misinterpreted or where Ofwat's approaches have been inconsistently applied across companies. In some instances, we have provided additional evidence to further justify previously addressed arguments that we believe need further consideration.

3.4. Havant Thicket

We are broadly supportive of the position Ofwat took in the Draft Determination. However, there are a few areas that we believe need further clarification or development ahead of the Final Determination. Ensuring customer parity between us and Portsmouth Water, robust financeability for the execution of the Havant Thicket Reservoir and development in the regulatory framework (on topics such as cost and revenue allowances, delivery incentives and balanced risk exposure) are all areas requiring clarity.

4. Moving forward

In making our draft determination response we are keen to build on the progress made through our positive engagement during the IAP and continue to address the actions you have identified. We look forward to engaging positively with you between now and the final determination. Having moved significantly further than most companies in our acceptance of the IAP cost challenges, we have necessarily provided high quality evidence to support those representations where further intervention would take us beyond a reasonable level of efficiency challenge. We have been careful to ensure that these representations are constructive and support the outcomes our customers' value.