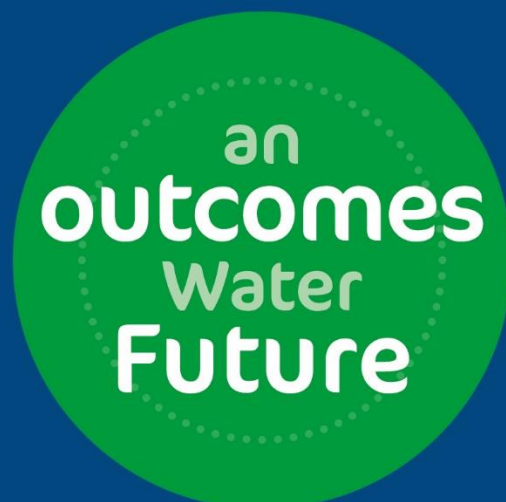


Business Plan 2020-2025
Response to Ofwat's July 2019 Draft Determination
for Slow-track Companies
Supporting information



Delivering Outcomes for Customers



**South West
Water**



**Bournemouth
Water**

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Executive Summary

1. In the publication of the July Draft Determinations for slow-track companies, Ofwat has made some adjustments to Outcome Delivery Incentives (ODIs).
2. We are pleased that on the whole our ODI's in the round remain broadly in line with our Draft Determination following some changes at the Initial Assessment of Plans (IAP) stage with the Early Certainty Principle (ECP) providing some protection in this area.
3. This view of our ODIs is based on retaining the internal sewer flooding enhanced outperformance rate, which we represented on at our Draft Determination in April. The intervention at Draft Determination if applied would have a material impact on our outperformance payments (up to £1m outperformance a year).
4. We are restating our initial Draft Determination representation regarding internal sewer flooding enhanced outperformance rates and there are some clarifications and observations that we are making within our representation as follows on:
 - Leakage performance commitment rates
 - Priority services register reporting guidance
 - Pollutions
 - D-MeX
 - Compliance risk index (CRI).

Internal sewer flooding enhanced outperformance rates

5. We consider our proposed internal sewer flooding enhanced rate to be based on customers' views, appropriate and balanced and not an outlier compared to other companies enhanced rates. Furthermore, changes to the ODI incentive rate at this stage seems to be counter to the Early Certainty Principle to which we opted into. The change from Initial Assessment of Plans to Draft Determination has a material impact on our outperformance payments (up to £1m outperformance a year).

Customer views

6. Our customers have told us that internal sewer flooding is arguably the most extreme breach of service, and whilst customers consider our performance in this area to be good relative to other companies, it remains a key priority for our customers to do more to prevent internal sewer flooding, especially around repeat events.
7. Our customer valuation to prevent sewer flooding reflects customers' views that repeat internal flooding is intolerable. Our valuation evidence recognises that we have dealt with many internal sewer flooding issues and often it is the most expensive and severe cases of internal flooding that remain.
8. We thoroughly tested our customer valuations for reducing sewer flooding with customers and with the WaterFuture Customer Panel as part of our triangulation process. The enhanced rate applied to this valuation is also based on customer evidence. This analysis showed the value of the standard rate should be £6m per unit, and the value of the enhanced rate should be £12.4m per 10,000 sewer connections.
9. We accept Ofwat's view that standard incentive rates for the common performance commitments should more closely align – and we support the proposed change in the incentive rate in this area to £3.52m per 10,000 sewer connections. However, we do not consider a proportionate reduction in the outperformance enhanced rate to be required.
10. Maintaining the enhanced rate at our proposed £12.4m per 10,000 sewer connections aligns with customers' views on the importance of driving improvements in the internal sewer flooding metric, and the overall package of incentives (RORE range). Lowering this would move us away from our customers views on the right level of incentives we should have in our business plan.

The recommended industry approach to estimating enhanced rates

11. A step change in industry frontier performance in this metric requires considerable innovation and investment. The benefits to our customers – and the rest of wastewater customers through our sharing of our approaches, processes and knowledge – will be significant.
12. Maintaining our enhanced rate would mean the enhanced rate multiplier (i.e. the ratio of our standard to enhanced incentive rate for outperformance) will be 3.5. As shown below, this is a reasonable and proportionate multiplier, which will provide strong incentives to drive truly leading sector performance in this key metric.
13. We note the 2017 Frontier Economics¹ report prepared for Ofwat provides industry guidance that enhanced rates need to reflect company size and the customer value of investment and innovation.

¹ Frontier Economics (2017). "Performance Commitments and Outcome Delivery Incentives at PR19: A report prepared for Ofwat" 28 March 2017

14. A further publicly available 2018 Frontier Economics² report was commissioned by another water company to further clarify the principles and demonstrate appropriate enhanced rates in line with the 2017 report for Ofwat. The 2018 report notes:

“This multiplier would need to reflect two factors.

- *First, the size of the water company relative to the industry size. The smaller the company relative to the industry, the greater the ratio between:*
 - o *The customers in other companies to benefit from improvements in sector performance; and*
 - o *The own customer base that pays the standard incentive rate.*
- *Second, the company’s customer valuation of the measure relative to the valuation of customers of other companies. The more customers of other companies value this metric compared to the company’s own customers, the more they will benefit from improvements in sector performance.”*

15. It is clear from other companies’ business plans, and the value of the standardised rate applied by Ofwat across the industry, that all customers of wastewater companies value this metric highly. Extract from 2018 report:

Figure 4 Calculation of the multiplier for sewage services (unadjusted)

Company	Total number of properties connected to sewerage services	Unadjusted multiplier
Anglian Water Services	2,683,041	9.03
Dwr Cymru Cyfyngedig (Welsh)	1,416,267	17.10
Northumbrian Water Ltd	1,242,969	19.49
Severn Trent Water Ltd	3,947,510	6.14
South West Water Ltd	711,701	34.03
Southern Water Services Ltd	1,919,628	12.62
Thames Water Utilities Ltd	5,640,021	4.29
United Utilities Water Plc	3,228,703	7.50
Wessex Water Services Ltd	1,197,968	20.22
Yorkshire Water Services Ltd	2,233,735	10.84
Total	24,221,543	
	Maximum	34.03
	Minimum	4.29

Source: 2012-13 data from Ofwat’s PR14 feeder models; domestic and non-domestic properties. Includes properties receiving sewage only services and properties receiving water and sewage services.

16. Frontier Economics compute the enhanced rate multiplier for all wastewater companies based on their size and similar standard valuations. This shows the minimum enhanced rate multiplier should be 4.3, and the South West Water enhanced rate multiplier should be much higher (estimated at 34) – prior to applying any relevant adjustments that reflect time delays of benefits being transferred, the ability of other companies to replicate innovation, and the need for rates to be proportionate and balanced.
17. Whilst we would recognise a multiplier of this magnitude is disproportionate and out of line with our customers’ views – it does highlight that that if we drive a step change in frontier performance, the wider benefits of sharing our innovations, processes and approaches would be very substantial and should be encouraged.

² Frontier Economics (2018). “Enhanced Incentives: A note prepared for Anglian Water”, May 2018

Other companies' rates

18. We have noted other companies proposed enhanced rates. The multipliers proposed in September 2018 business plans was generally in the range 1.5 to 5 (this excludes very high outlier rates such as those proposed by Yorkshire Water), with an average multiplier of 3-4. Hence our proposed enhanced rate for this metric is in line with other companies' proposals for enhanced rates.

Early Certainty Principle

19. A final and important point is around the Early Certainty Principle. We have agreed to opt into the Early Certainty Principle. This states that there will be no changes to the ODI incentive rates; changing the internal sewer flooding enhanced rate seems to be counter to this principle.
20. We note that Ofwat indicated in its initial assessment of plans that it would continue to protect customers by not applying the Early Certainty Principle if a company's outperformance payment is the highest, or the underperformance penalty rate was the lowest of all the companies.
21. Our review of other companies' Draft Determinations shows that our standard and enhanced outperformance rates for internal sewer flooding are not industry outliers, as shown in the table below:

£m per unit	Out performance rate	Under performance rate	Enhanced out performance rate	Enhanced under performance rate
UU	2.200	-8.275	-	-
SVT	18.720	-22.602	28.080	-33.904
SWW	3.520	-9.512	12.4 / 7.040	-19.024
Wessex	3.296	-4.715	22.29	-22.292
Yorkshire	8.435	-8.435	14.873	-21.311
Anglian	10.994	-21.122	-	-
NWL	2.253	-3.247	-	-
Southern	5.557	-5.557	-	-
Thames	16.762	-21.635	-	-
Welsh	4.570	-5.484	-	-

Internal sewer flooding ODI rate: £m per 10,000 sewer connections

22. Therefore, under the Early Certainty Principle it does not seem appropriate to change the enhanced outperformance rate.

Ofwat approach to benchmarking positive externalities

23. We have reviewed the Ofwat approach to quantifying the benchmarking externality for enhanced ODI rates as part of the slow track Draft Determinations³. This outlines a seven-step approach.
24. We have replicated this approach so far as is possible for internal sewer flooding. The adjustment factor in Step three of the approach involves more detailed willingness to pay data than we have access to and has been broadly estimated.

³ Delivering outcomes for customers policy appendix

25. From replicating this seven-step process we observe that the expected adjusted valuation for enhanced performance is not dissimilar to our proposals in September 2018: namely that the enhanced ODI rate should be c.£12m, based on a standard ODI rate of c.£6m.
26. However, in replicating this seven-step process we note that the benchmarking externality is significantly scaled down for South West Water based on our size (746k households) relative to a notionally average sized company (2,429k households). This is contrary to the approach recommended by Frontier Economics (2018): as the smallest wastewater company, the potential for all other wastewater customers to benefit from our sharing of innovation is particularly large and the enhanced ODI rate should be increased to reflect that.
27. The approach recommended by Frontier Economics (2018) reflects the sound principle that the scaling factor should derive from size of the potential positive externality. The size and hence value of this externality ought to increase with the number of households who are the beneficiaries of the externality. With more customers external to South West Water, than say external to Yorkshire Water or Anglian Water, then the pool of potentially benefiting customers is by definition greater with enhanced levels of performance in South West Water compared to other larger companies.
28. A comparable analogy would be the example of a below average size pharmaceutical company that brings to the market a radically new innovative and successful cancer drug therapy. The reward in this case would be revealed through the increase in overall market share for this below average size company. This market share “reward” would be proportionally greater than if the innovator had been the company with the largest market sector. Over time as well, as the new drug is copied and replicated by larger competing companies the overall benefit (and externality) would grow.
29. The Ofwat approach does precisely the opposite in that a company that is smaller than the notional average company would receive, all other things being equal, a reduction in its enhanced payment rate, for the sole reason of being smaller than the average. We believe this can only act as an unintended dis-incentive to us and other smaller companies who are often at the frontier of industry performance and driving it forward.
30. We would also note Frontier’s further point that scaling factors should be expected to be broadly similar across companies (irrespective of size). On this basis we believe there is a stronger case for applying similar adjustments that are independent of company size. This at the very least would be consistent with the objective of a level of playing field (in respect of size) and allow other more relevant factors like customer valuations to be the primary determinant of the level of enhanced outperformance rates.

Summary

31. Finally, our stated approach to sharing knowledge and benefits to other companies supports our enhanced rate. We have reviewed other companies’ business plans and from this we consider that we have the most comprehensive approach to sharing knowledge and providing genuine insights into our experiences, processes, and methodologies for sewer flooding. This confirms that the positive impact of our sharing of innovation with other wastewater companies will be significant and warrants our proposed enhanced rate.
32. We consider our proposed enhanced rate to be appropriate and in line with the agreed Early Certainty Principle. It fully reflects customers valuation for this metric and the benefits of sharing our innovation with the rest of wastewater customers and will give strong incentives to deliver for our customers in this important aspect of service.

Leakage performance commitment rates

33. We have noticed an error in our stated underperformance incentive rates for leakage contained within the South West Water – Outcomes performance commitment appendix issued in April 2019 as part of the PR19 Draft Determination. This is the result of a transposition of rates on a per MI/d basis and % reduction basis.
34. We are restating the correct figures to ensure that at Final Determination the correct rates are used to calculate any underperformance penalties.

	INCORRECT RATES AS STATED IN DD OUTCOME PERFORMANCE COMMITMENT APPENDIX	CORRECTED RATES
Incentive type	Incentive rate (£m/unit)	Incentive rate (£m/ML/d)
Underperformance payment – standard	-0.725	-0.615260
Underperformance payment – enhanced	-1.450	-1.230520
Outperformance payment – standard	0.370	0.370000
Outperformance payment – enhanced	0.740	0.740000

Supporting Information

35. In our September 2018 business plan submission – Delivering outcomes for customers element plan, page 66, we provided leakage rates in both MI/d and % terms.
36. In our App1 data file we presented this information but on the per % reduction basis.
37. As part of Ofwat’s Initial Assessment of Plans feedback and fast-track acceptance, Ofwat intervened and requested that we reduce our outperformance rate from £727k to £370k per MI/d. No changes were proposed for the underperformance rate.
38. We accepted this change and updated our App1 data. However, we entered the rate indicated by Ofwat on a MI/d basis, when our App1 unit description is % change in leakage. We should have adjusted the proposed rate from Ofwat to a % reduction rate or changed the table, so all values were entered on a per MI/d basis.
39. In our Draft Determination, Ofwat confirmed this change, however since the publication of the July Draft Determinations and reviewing our performance commitments again we have noticed that in the April Draft Determination the table of incentive rates contains a mix of the rates on a per % basis, and a per MI/d basis.

Incentive rates

Incentive type	Incentive rate (£ million/unit)
Underperformance payment - standard	-0.725
Underperformance payment - enhanced	-1.450
Outperformance payment - standard	0.370
Outperformance payment - enhanced	0.740

Source: Ofwat, PR19 Draft Determinations: South West Water – Outcomes performance commitment appendix, April 2019

40. Ofwat states “Incentive payments relate to performance changes expressed in megalitres per day (Ml/d).” Therefore, the table should read:

Incentive type	Incentive rate (£m/unit)
Underperformance payment – standard	-0.615260
Underperformance payment – enhanced	-1.230520
Outperformance payment – standard	0.370000
Outperformance payment – enhanced	0.740000

41. We request that Ofwat corrects the table so that all figures are shown in Ml/d terms. We recognise that our approach of providing all rates in both Ml/d and % terms has potentially caused confusion, and in the future, we will focus on rates in Ml/d terms only.

Priority Services Register reporting guidance

42. We still remain concerned that with the guidance that was published alongside the Draft Determinations in July, the 90% target for attempted contacts is potentially unachievable given the way the methodology is currently set out.
43. We acknowledge that our observations on the methodology stated in an email to you on the 18 May have been considered, however with the definition of attempted contact only being limited to proactive contact means that the target cannot be reached nor, do we believe that this is in the best interest of the customer. To reach the target would mean potential multiple contacts to ‘vulnerable’ customers who have already provided this information.

Part one of the data-checking element of the common performance commitment

44. Under this criterion of the common performance commitment companies are required to attempt to contact 90% of households on the priority services register every two years (45% for the first year).
45. An ‘attempted contact’ is defined as a *proactive* attempt to engage with the customer, whether successful or not.
46. However, where a customer’s details are updated or confirmed following the customer contacting the company regarding another matter, or where the updated or confirmed details have been received through data-sharing arrangements with third parties such as Distribution Network Operators (DNOs), these are not included in the definition of an ‘attempted contact’.

47. In the example below, 1,000 PSR customers are eligible to have their details checked in a two-year period, and all customers are contacted through a mix of proactive and reactive methods. The table shows how these would be classified for reporting under the reporting guidance for the common performance commitment.

Type	No. customers contacted	Proactive/reactive	Classification for reporting
Attempt to contact via phone/email/letter – no response received	350	Proactive	Attempted contact
Contact via phone/email/letter – confirmation/update received	400	Proactive	Attempted contact and Actual contact
Customer rings in regarding account, agent confirms/updates PSR details during call	75	Reactive	Actual contact
Updated/confirmation of details received via data-sharing agreements with DNOs	175	Reactive	Actual contact

48. Under the current definitions, despite all 1,000 customers having an attempted or actual contact, the company would only reach 75% for this element of data-checking⁴.

49. In this scenario, to reach 90% a company would have to attempt to make contact with customers for whom they have already confirmed or updated details through a reactive contact. This is not in the best interests of customers who have told us they strongly support a ‘tell us once’ principle of PSR data-sharing. Indeed, the Ofwat reporting guidance recognises this, noting that Ofwat “expect companies to be sensitive to customer circumstances when developing their approach, including that their attempts do not cause any undue stress” – making attempted contact with a customer who has already updated or confirmed their details is likely to cause undue stress to customers in vulnerable circumstances.

50. Additionally, as we expect data-sharing with DNOs will become more prevalent through the course of this period it is likely that an increasing number of data updates will be received through this method making it increasingly difficult for companies to reach 90% for the attempted contact element.

Recommendation

51. To maximise the benefits to customers of PSR data-sharing and to ensure that customers in vulnerable circumstances are not subject to unnecessary and potentially stressful repeat contact, as well as reducing the administrative burden for companies, we propose this part of the data-checking element should be re-defined to include reactive as well as proactive contacts in order to avoid the scenario described above.

Pollutions

52. We note that with regard to Hafren Dyfrdwy the proposed targets for pollution reflect the size of their sewer network. In their September 2018 business plan Hafren Dyfrdwy indicated upper quartile performance equates to 1.5 to 2 pollution incidents a year – a target they consider unachievable and unrealistic.

⁴ (350+400)/1000 = 75%

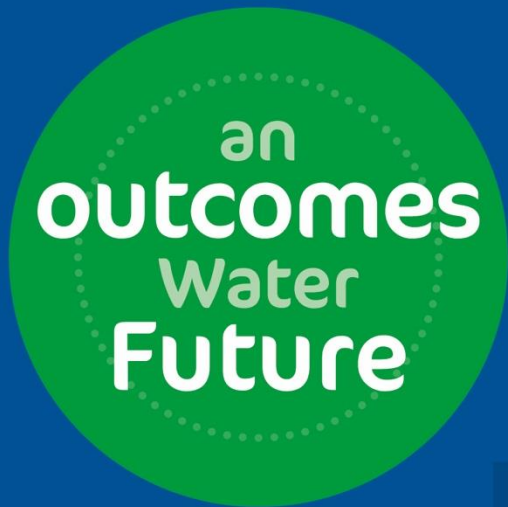
53. Ofwat's Initial Assessment of Plans recognises the sewerage system is small and agrees it is not appropriate to set targets on the basis of upper quartile. In making this decision, Ofwat recognises Hafren Dyfrdwy is out of step with other companies, and performance commitment levels need to reflect that.
54. The point we would stress is that this principle is also applicable to other companies. The way that all wastewater networks are maintained and operated reflects their unique characteristics: the size of the operating region (size of geographical area, length of network) the density of connections, the nature of the landscape and number of wastewater treatment works and pumping stations
55. Our current sewer network reflects legacy decisions, i.e. the size of the operating region, the density of connections, and the nature of the landscape has driven investment in the sewer network. The size and structure of our sewer network (e.g. layout, sewer type, sewer diameter, etc) directly reflect these factors.
56. Customers priorities, legislative drivers, and changing weather patterns have also had an important part to play – we have had a strong focus on delivering region-wide environmental improvement and flood reduction programmes over the past 20 years to meet the needs of customers and contribute towards the region's beautiful environment.
57. With respect to pollution, most of our sewers remain of small diameter – which are more prone to blocking. To that extent, our sewer system is more like the network of Hafren Dyfrdwy, rather than larger companies such as Thames Water or United Utilities.
58. Pollution on the network is best prevented by investing to upgrade/upsue existing sewers, thereby preventing blockages (and collapses). Alongside this, a robust maintenance and sewer strategy is needed to change the operation of the network, proactively diagnose potential issues before they occur, and deal with issues effectively when they arise (before they become categorised pollution incidents). This is the essence of our plans and operations.
59. But this is not a short-term challenge. And this cost is not reflected in the totex assessment.
60. Recognising the importance that our customers and stakeholders continue to place on the environment in the south west, we maintain support for achieving upper quartile pollution performance commitment levels in our business plan. But we consider it important to reiterate that this is an exceptional challenge for South West Water, which we hope our stakeholders and Ofwat recognise.

D-MeX

61. We also note that Ofwat are minded to increase the incentive rates of +2.5% and -5% to +6% and -12% respectively, of annual developer services revenue for D-MeX. Although Ofwat signalled in the March 2019 documents that there is a good case to increase the level of the financial incentive to reflect the high impact service to developers can have on the wider economy and society, Ofwat also recognise that this is a new mechanism and that only after the pilot year, shadow year and a review of the metrics will they gain full confidence in D-MeX.
62. Therefore, we would propose that Ofwat does not include this increase within the Final Determination and sets incentive rates which are more balanced between under/outperformance and comparable with other customer metrics.

Compliance Risk Index (CRI)

63. A final observation we make is around the new measure for water quality: the DWI's Compliance Risk Index (CRI).
64. We consider CRI to be a useful way to measure drinking water compliance. This new measure is a risk-based monitoring methodology, used to measure the risk arising from treated water compliance failures. It allows the DWI to scrutinise company performance on the basis of their risk of failing to meet drinking water requirements.
65. All water companies have a zero target around CRI. As a new measure, in its Initial Assessment of Plans publication, Ofwat introduced a standardised deadband of 1.50 for all companies in all years. This was calculated based on the observed upper quartile performance and forecast upper quartile deadbands proposed by companies.
66. It important to get the deadband right: so that it reflects the right balance between ensuring stretching company performance and allowing time to reach 100% compliance when there is measurement volatility and legislative changes that need to take effect.
67. As we noted in our initial Draft Determination response, for drinking water quality it is especially important to get the balance right. A deadband that is too narrow could see many companies penalised during AMP7, which in turn would mean major industry improvements could be branded a failure and potentially erode public trust on the quality and safety of their drinking water.
68. In the July Draft Determinations Ofwat recognised that flexibility is important as it will take time for performance levels to reach 100% compliance for this new measure. It subsequently increased the deadband for the first two years of PR19: i.e. the CRI deadband score is 2.0 in the first two years of the period, and 1.5 for the next three years.
69. We support Ofwat's flexible approach adopted in July. However, we are very disappointed that the change in the deadband has not been applied to South West Water's performance commitment.
70. We take our commitment to drinking water quality seriously. Drinking water quality is our customers' number one priority. It is also a very sensitive measure, whereby failure to meet regulations and standards can damage trust and confidence in everything that we do.
71. There is a real risk that we continue to deliver exceptional water to our customers – passing the water quality tests at customers' taps – whilst achieving CRI levels aligned or better than other companies in the industry yet be penalised through the ODIs. This perverse situation could seriously alarm our customers and damage their perceptions of the drinking water we provide.
72. We are therefore disappointed that we are the only water company that faces this risk. We would hope that Ofwat reconsider its position with respect to deadbands for this measure so that all water companies have the right targets and deadbands in place.



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