April 2014

Water today, water tomorrow

2014 price review risk-based review – recommendation to Ofwat's Board on South Staffs Water's business plan categorisation

www.ofwat.gov.uk

Contents

1. Executive summary

This paper summarises our assessment of South Staffs (incorporating Cambridge Water) for the pre-qualifying process. The pre-qualifying process assesses the quality of each company's business plan using a subset of the risk based review test criteria previously agreed with Board.

Appendix 1 visually illustrates the tests in scope for pre-qualification.

We recommend that **South Staffs** is classified as a **not pre-qualified for enhanced** company. This is because significantly more evidence or more evidence is required in relation to the following tests:

Significantly More Evidence is Required

- Legacy adjustments (wholesale water) – South Staffs provided little or no evidence that its proposed adjustments are in line with our guidance and reflect the company's 2010-15 performance.

More Evidence Required

- Performance commitments (wholesale water and household retail) - the company has scored more evidence required or significantly more evidence is required on six out of eight applicable tests. They have scored well in some areas but insufficient evidence has been found to show that:
    - its performance commitments represent value for money;
    - its outcome commitments are consistent with longer term customer interests; and
    - its performance commitments can be measured and recorded consistently and that there is appropriate governance and quality assurance processes in place.
- Wholesale Cost assessment - South Staff's proposed totex is £409 million so South Staffs misses the acceptable threshold by approximately £11 million or 3% of totex.
- Average cost to serve (ACTS) adjustments (household retail) – South Staffs did not provide sufficient evidence for its proposed ACTS adjustments to reflect input price pressures and bad debt.

- Affordability – South Staffs has not demonstrated a robust approach to testing it proposals with its customers for affordability in the current period or in the longer term.

1.1 Marginal tests

South Staffs does not have any marginal scores at test level.

2. Background

2.1 Brief description of South Staffordshire Water

South Staffs is a water only company (WoC) that supplies 669,000 water customers in England.

South Staffs is proposing wholesale totex of £409 million compared to £382 million in 2010-15. The increase is driven primarily by rising power costs and maintenance of service reservoirs and nitrate removal plants. South Staffs has a regulatory capital value (RCV) of £310 million. The average water bill in 2014-15 is £144 in the South Staffs region and £129 in the Cambridge region.

In terms of **past performance**, South Staffs performed well in the following areas:

- scored 1st with their service incentive mechanism (SIM) score for 2013 of 88 (2012, 84, 4th); and
- it had no Environment Agency or Drinking Water Inspectorate (DWI) prosecutions during the period.

South Staffordshire Water did not experience any significant past performance issues in 2010-15.

2.2 Business plan overview

This section provides an overview of South Staff's business plan and its main features.

Overview and challenges

South Staffs wishes to maintain or upgrade where necessary its current infrastructure but it is not proposing any significant new schemes. It has not set very challenging targets and it already meets some of them, but cites the reason for this being the lack of appetite amongst customers for additional expenditure as current service levels are largely acceptable.

The biggest challenge South Staffs sees is its power costs which it believes are high due to its topography and high pumping head. It also has two aging service reservoirs which require investment and a number of nitrate treatment works which require upgrading. There is little mention in this plan of the Cambridge Water area which became part of South Staffs Water following a merger in 2013.

The three main areas of investment are trunk mains, service reservoirs and nitrate removal sites.

Outcomes

Table 1 South Staffs proposed outcomes and success measures

Outcome	Performance commitments	Incentive type	Allocation
Excellent water quality (now and in the future)	How well the water meets standards set by the DWI (mean zonal compliance – MZC)	Penalty	Wholesale
	Acceptability of the water to customers	Reputational	Wholesale
	Working with farmers and other landowners to improve the water draining into watercourses (catchment management)	Reputational	Wholesale
Secure and reliable supplies	How often and for how long customers are without water	Two-sided	Wholesale
	How serviceable and resilient our assets are (infrastructure – for example, reservoirs, treatment works and water pipes)	Penalty	Wholesale

Outcome	Performance commitments	Incentive type	Allocation
	How serviceable and resilient our assets are (non-infrastructure – for example, computers)	Penalty	Wholesale
	How South Staffs works with house builders to promote the installation of water efficient devices in the Cambridge region	Reputational	Wholesale/Retail
An excellent customer experience to customers and the community	How satisfied customers are, using independent surveys	Reputational	Retail
	Customer complaint levels per 1000 customers	Reputational	Retail
	The company's involvement with the local community and engagement with customers	Reputational	Retail
	Service Incentive Mechanism (SIM) score	Reputational	Retail

Outcome	Performance commitments	Incentive type	Allocation
Operations that are environmentally sustainable	How the company helps customers to use water wisely, particularly in drought situations (household per capita consumption)	Reputational	Retail
	How much the company reduces its carbon footprint	Reputational	Wholesale
	How well the company works to reduce leaks in the South Staffs region	Two-sided	Wholesale
	How well the company works to reduce leaks in the Cambridge region	Two-sided	Wholesale
	The companies' biodiversity activity	Reputational	Wholesale
Fair customer bills and a fair return for South Staffs investors	How affordable and fair bills are, value for money.	Reputational	Wholesale
	How effectively the company supports customers in debt	Reputational	Wholesale

Outcome	Performance commitments	Incentive type	Allocation
	The extent to which customers are able to benefit from any significant company windfall profits. Financial windfalls will be shared with customers.	Penalties	Wholesale/Retail

(In general we are considering how we can provide feedback to companies where the proposed outcomes and performance commitments look more output or input-focused as opposed to outcome-focused).

Costs

South Staffs proposes a wholesale totex of £409 million for AMP6. The increase in totex is mainly due to an increase in capital maintenance and resilience levels of spend due to some large expenditure items (not currently needed in the AMP5 period) for reservoir replacements and refurbishment of nitrate treatment sources, which are large assets in a small company.

South Staffordshire water has not proposed any adjustments to its wholesale costs.

South Staffs proposes the following major water infrastructure projects.

- Borehole maintenance programme £1 million.
- Groundwater nitrates £5.8 million.
- Treatment gas independence £3 million.
- Surface water reservoirs £0.9 million.
- Surface water treatment works £7.6 million.
- Service reservoirs and water towers £7.5 million.
- Booster pumping stations £1.7 million.

South Staffordshire is seeking the following adjustments to its retail costs;

- bad debt; and
- retail price escalation .

Risk and reward

South Staffordshire Water proposes the following regulatory instruments to address the risks identified in its analysis.

Table 2: South Staffordshire Water proposed regulatory instruments to address risk

Risk area	Rationale	Instrument type	Ranges
Traffic Management costs	Many councils are preparing to commence charging for "permits to work" in order to work on the highway. This would impact on planned work, for example main-laying and daily operations (for example, leak repairs). It appears the costs would be unavoidable; they are not fines for over-runs that can be managed through efficiency. Due to constraints on local authority income, there is a real potential of cost escalation in this area.	Notified item	
Increases in debt costs	Whilst now under control, external changes from further loss of manufacturing jobs or reductions in welfare benefits (for example, Universal Credit introduction) could impact on debt levels and the costs of collection.	Notified item	

South Staffordshire Water is proposing a household retail margin of 0.5% and a non-household retail margin of 2%.

Financeability and affordability

South Staffs proposes a vanilla WACC of 4.46%; 6.6% is due to cost of equity and 3.3% due to cost of debt. The assumed gearing is 65.10%. South Staffs has included a small company premium in its WACC.

South Staffs states that it has not adjusted the pay as you go (PAYG) rates from the forecast opex/capex split of 69.06%, and is proposing an RCV run-off rate of 5.87%.

South Staffordshire Water is targeting the following credit ratio: BBB+/Baa2 which the company considers is in line with current performance.

South Staffs business plan will result in an inflation-only bill increase so a 0% increase in real terms over the regulatory period. In terms of bill profiling South Staffordshire proposes to keep bills flat in real terms, only increasing bills by inflation.

2.3 Stakeholder views

The combined South Staffs and Cambridge Water customer challenge groups (CCGs) are able to give overall support for the South Staffs business plan.

Although the CCGs recognised that South Staffs had a track record of excellent customer service as measured by the SIM and combines this with low bills relative to other suppliers including many much larger water companies there were a number of issues where the CCG had to challenge South Staffs quite strongly, for example in relation to it's proposed bill increase of 2%.

In the final Business Plan the CCG states that proposals for incentives and penalties appear balanced, and likely to encourage company behaviour that reflects customer priorities.

The CCG notes that the acceptability testing carried out by South Staffs was based on the earlier draft plan. The CCGs are pleased with the company's decision to present in an even-handed and transparent manner, both the result that 82% of respondents agreed with the proposed price rise when using today's prices, and the result that this fell to 59% when inflation was taken into account. The CCGs believe that this latter figure does not compare well with expected levels of acceptability, but agree that it is reasonable to assume that further research on the basis of the new business plan proposals would be likely to be more favourable. The CCGs recommend that the company conduct a final piece of acceptability research after the publication of final determinations, using a methodology agreed across the sector, to allow for greater comparability.

3. Evaluation

We recommend that South Staffs is classified as a not pre-qualified for enhanced company.

Each business plan was subjected to a rigorous review and scoring process, as previously agreed with the Ofwat Board (and as developed through the process). The resulting analysis was presented to the Senior Responsible Owner, Accountable Leads, Legal and Quality Assurance who challenged the findings and carried out a holistic consistency check across all company submissions. This provided assurance on the robustness of the process, verification of the analysis and allowed both a quantitative and qualitative comparative view of company performance to be made.

We are satisfied that the internal methodology has been applied correctly and the evidence reported in this recommendation has been assured with the Accountable Leads.

The text below explains our assessment against each individual risk-based review test, for the following business plan elements: household retail, non household retail and wholesale water, as well as at the whole company level.

The company and element dashboards provide an overview for all tests undertaken.

If Board feels they need more evidence to reach a decision on the company's classification then the following sources of evidence are also available on request:

- element scorecards;
- individual test scorecards;
- outputs of the models used to support the risk-based review assessment including our estimates of wholesale costs and legacy adjustments;
- business plan tables; and
- the company's business plan.

3.1 Household retail

The table below indicates that South Staffs Water has scored **more evidence required** for 50% or more of the relevant tests for the household retail element.

Table 3

Area	Test	Name	Score
Outcomes	Test 1	Customer engagement and WTP	**Acceptable (B)**
	Test 2	Performance commitments	**More evidence required (C)**
Costs	Test 5	Retail cost allocation	**Exceptional (A)**
	Test 6	ACTS adjustment	**More evidence required (C)**

The **'consumer engagement and willingness to pay (WTP) information'** test was assessed as **acceptable (B)**

Overall, SSC has provided sufficient and convincing evidence that they have carried out an effective customer engagement process, therefore **it is acceptable**.

The **'performance commitment'** test was assessed as **more evidence required (C).**

South Staffs has mixed results across the evaluation criteria for this test. It is acceptable (and scores exceptional (A) or acceptable (B)) on three criteria as it has provided convincing evidence.

- Allocation of commitments to separate controls: **Exceptional (A)**.
- Consistency assurance on statutory and licence obligations: **Acceptable (B)**.
- Evidence of track record in relation to future delivery. Justification of changes to performance levels: **Acceptable (B)**.

However South Staffs has scored as significantly more evidence is required on the criterion which assesses how the proposed commitments are going to be measured, recorded and governed. South Staffs has not effectively documented how the required data will be captured and assured and we have found insufficient evidence that the proposed commitments can be measured and recorded consistently.

It also required more evidence for the criterion which assesses whether it has provided evidence that its proposed commitments represent value for money. It has provided little or no evidence that two of its high significance performance commitments reflect value for money or that they are consistent with their track record.

The **'retail cost allocation'** test was assessed as **exceptional (A).**

Overall we considered that South Staffs retail cost allocation was exceptional on the basis that it is within 2% of our expectations and is materially compliant with the business planning guidance. This test was split into two parts.
For the first half of this test: retail and wholesale allocation, South Staffs household / non-household retail costs were within 2% of our own allocations based on the number of customers (adjusted for known policy changes) with a variance from expectation of -1.5%. Also SSC's cost allocation between retail and wholesale is materially in accordance with the business planning guidance.

For the second half of the test: allocation of costs between household and non-household, South Staffs' allocation between retail and wholesale is within 2% of our expectation based on the 2012-13 regulatory accounts (adjusted for directly attributable costs) with a variance from expectation of -1.9%. Also, SSC's cost allocation between household and non-household is materially in accordance with business planning guidance. South Staffs retail costs are either directly attributed or allocated on customer numbers.

The **'average cost to serve (ACTS) adjustment'** test was assessed as **more evidence required (C).**

South Staffs proposed that its ACTS should be adjusted to reflect input price pressure and bad debt.

South Staffs has provided insufficient and unconvincing evidence in relation to its proposed retail cost adjustments. South Staffs proposed more than one reason for the cost adjustment; we have assessed each reason separately. The criterion score is the lowest of the individual assessments which in this case was more evidence is required. The input price pressure adjustment proposed (6.6%) exceeded our materiality threshold and that there is little or no evidence to support the size of the adjustment. South Staffs also scored more evidence required on the assessment of their bad debt which also exceeded our materiality threshold with the level of adjustment proposed (3.9%) along with insufficient evidence that bad debt costs driven by deprivation are outside efficient management control. The level of adjustment proposed is not supported by strong and reliable evidence calculated using a suitable approach.

3.2 Non-household retail

There is only one test in this element, retail cost allocation. Our assessment of this test is the same as the cost allocation test applied in the household control. We have assessed this test as acceptable.

3.3 Wholesale water

The table below indicates that South Staffs Water has scored **more evidence required** for over 50% of the relevant tests for the wholesale water element.

Table 4

Area	Test	Name	Score
Outcomes	Test 1	Customer engagement and WTP	**Acceptable (B)**
	Test 2	Performance commitments	**More evidence required (C)**
Costs	Test 4	Wholesale cost assessment	**More evidence required (C)**
Other considerations	Test 14	Adjustments to 2015 – 2020 price controls	**Significantly more evidence required (D)**

The **'consumer engagement and willingness to pay (WTP) information'** test was assessed as **acceptable (B)**.

The test score and analysis of the evidence is identical for all controls. Please see the commentary above in relation to household retail control.

The **'performance commitment'** test was assessed as **more evidence required (C)**.

South Staffs has mixed results across the evaluation criteria for this test. It is acceptable (and scores either acceptable (B) or exceptional (A)) on three criteria as it has provided evidence that:

- allocation of commitments to separate controls: **exceptional (A)**;
- outcome commitments consistency with methodology requirements: **exceptional (A)**; and

- consistency assurance on statutory and licence obligations: **Acceptable (B)**.

However South Staffs has scored as significantly more evidence required for:

- evidence of track record in relation to future delivery. Justification of changes to performance levels - Overall we have found little or no evidence to justify South Staff's delivery of future performance commitments in the context of its past performance;
- outcome commitments consistency with long term customer interests – South Staffs has provided insufficient evidence that it has applied best practice approaches to ensure it has fully understood and quantified the risks to future customers and the environment and there is insufficient evidence that the company has a long-term vision for how outcome and performance commitments might change over time; and
- commitments measuring, recording and governance – South Staffs has not effectively documented how the required data will be captured and assured and we have found insufficient evidence that the proposed commitments can be measured and recorded consistently.

For the remaining two criteria South Staffs scores more evidence required.

- Reasonable assumptions in relation to future obligations – South Staffs has provided insufficient evidence of robust assumptions in relation to areas of anticipated statutory requirements and the national environment programme, which remain uncertain, for example the Environment Agency noted that they need to see the company reviewing reasonable assumptions about future statutory requirements which are currently uncertain.
- Commitments value for money – overall we have found insufficient evidence that South Staff's performance commitments reflect value for money, for example its performance commitment 'acceptability of water to customers', represents a worsening in performance for customers in 2015-20.

The **'wholesale cost assessment'** test was assessed as **more evidence required (C)**.

The first evaluation criterion for this test is whether South Staffs has provided sufficiently persuasive evidence to support any cost adjustments. South Staffs did not propose any adjustments to its wholesale costs. However we assessed its metering programme and its Outwoods Reservoir scheme to consider whether it might give rise to an adjustment, the Outwoods Reservoir scheme is fully covered by the implicit allowance in our modelling and, following a deep dive of the proposed costs, an allowance was made for the metering programme. Here South Staffs score **acceptable (B)**.

The second evaluation criterion is whether South Staffs has proposed costs that are consistent with our view of an efficient company. Here South Staffs score **more evidence required (C)**.

We revised the acceptable threshold from £359 million to £398 million, to take account of items including a proposed increase in business rates (£26 million) and pension deficit recovery costs (£7 million). South Staff's proposed wholesale totex is £409 million so South Staffs misses the acceptable threshold by approximately £11 million or 3% of totex therefore South Staffs scores **more evidence required (C)**.

Other considerations

The **'adjustments to 2015-20 price controls'** test was assessed as **significantly more evidence required (D)**.

South Staffs scores **significantly more evidence required (D)** for the first criterion and **more evidence required (C)** for the second criterion in this test. Having analysed their plan we conclude that South Staffs has proposed the following legacy adjustments:

- service incentive mechanism (SIM): £2.9 million (in total);
- revenue correction model (RCM): £10.6 million (in total);
- opex incentive allowance (OIA): £3.8 million (in total);
- change protocol (logging up/down/shortfall): no claims; and
- capital expenditure incentive scheme (CIS): no adjustment.

For the first criterion – whether South Staff's calculation of adjustments to 2015-2020 prices are in line with Ofwat guidance and tools – we consider South Staffs has only provided sufficient evidence to demonstrate the basis for its SIM adjustment.

For the OIA adjustment, South Staffs provided insufficient and unconvincing evidence to demonstrate its adjustment was in line with Ofwat methodology and tools:

- **OIA** –South Staffs failed to provide any commentary for the few inputs it included in the opex incentive allowance tables, for the two former companies of South Staffs and Cambridge. The overall opex incentive allowance for Cambridge was miscalculated as the company had not calculated the incremental value for 2012-13 correctly and also the effective tax rate used in the analysis for Cambridge was not explained and was not in accordance with the updated guidance issued.

For the remaining three adjustments, South Staffs provided little or no evidence to demonstrate these adjustments are in line with Ofwat guidance and tools,

- **CIS** – The company provided no adjustments for CIS and did not submit populated copies of the published CIS true-up model. We therefore consider that the company has provided little or no evidence to demonstrate compliance with Ofwat methodology and business plan guidance (including subsequent updates issued by Ofwat) in relation to the CIS adjustments to 2015-20 price controls.
- **Change Protocol** – South Staffs has not proposed any schemes for logging up or down. However, we were unable to confirm delivery of all the 2009 final determination outputs for each former company relating to supply/demand balance, drinking water service quality enhancement and serviceability outputs for which we are raising a number of potential logging down and shortfall counter claims.
- **RCM** – South Staffs has provided little or no evidence to demonstrate the basis of its adjustment or that it has followed the RCM guidance in relation to the back billing amounts claimed. Furthermore, we found little or no evidence to demonstrate that South Staffs has applied a consistent approach to reporting revenues and property numbers throughout the 2010-13 period or in forecasting these values for 2013-14 and 2014-15 years.

For the second criterion – how do the 2015 - 2020 price controls reflect the 2010 - 2015 performance? – South Staffs provided sufficient evidence to demonstrate its SIM adjustment is fair and reflects its performance. For two adjustments South Staffs has provided insufficient and unconvincing evidence that these are fair and reflect the company's performance in 2010-15:

- **OIA** – We consider that failure by the company to follow the PR09/04: The opex incentive allowance and the outperformance multiplier for 2005-10 methodology and business planning guidance (including subsequent updates issued by Ofwat) in respect of calculating the opex outperformance allowance for Cambridge and failure by the company to provide any explanation of the few adjustments made in each company analyses, means that the company has provided insufficient evidence to demonstrate that its proposed opex incentive revenue allowance adjustments for the water service are fair and appropriate based on each company's performance over the period 2010-15.

- **RCM –** For the RCM we consider that the lack of evidence to support its adjustment which is not in customers favour due to the 2013-14 and 2014-15 forecasts, means the company has provided insufficient evidence that its proposed adjustment is fair and appropriate.

For the remaining two adjustments, South Staffs has provided little or no evidence that these are fair and reflect the company's performance in 2010-15:

- **CIS** – we consider that the company has provided little or no evidence that the proposed CIS adjustments to 2015-20 price controls are fair and appropriate, having regard to the company's actual performance over the period 2010-15.
- **Change protocol -** the company has not proposed any adjustments but the company has provided little or no evidence that it has delivered all of its 2009 final determination defined outputs for the two former companies. As a result, we have raised a number of logging down and shortfall counter claims in this regard.

3.4 Whole company

Affordability

The **'affordability'** test was assessed as **more evidence required (C)**

In terms of South Staffs Water's plans to demonstrate affordability, South Staffs scores **more evidence required (C)** for the first criterion. Taking a balanced view of the relevant factors the company has not demonstrated a robust approach to testing its proposals with its customers for affordability. South Staffs has not tested their most recent plan of flat real bills. Its acceptability testing is based on a 2% bill rise. It received 59% acceptability for this proposal (when customers were asked about bill's including inflation). This suggests that there were significant concerns about a proposed bill increase and it is unclear whether the plan has been adjusted sufficiently in order to improve affordability of the plan. We do not consider that South Staffs has demonstrated that customers find its proposals affordable.

South staffs also provide some evidence of long term affordability and therefore scores **acceptable (B)** for the second criterion. This is because taking a balanced view of the relevant factors the company has demonstrated a robust approach to securing that its proposals are affordable to its customers in the longer term.

Other considerations

The **'Board assurance'** test was assessed as **acceptable (B).**

Taking into account and balancing each criteria the board assurance of this company's plan is assessed as **acceptable (B)**

The Board has signed off the entire plan. There is evidence that the Board has provided strategic leadership and directed the content of the plan and the proposed price limits. The evidence elsewhere in the plan is consistent with the statements that the Board has made about the quality of the plan. There is sufficient and convincing evidence that the Board has endorsed a statement that confirms that their company's performance commitments are consistent with relevant obligations and statutory requirements.

4. Reporting by exception to Board

In this section we report to the Board any material event or factual evidence that should be taken into account when considering this categorisation proposal.

The following tests produced marginal results.

- Nil

5. Recommendation

We recommend that **South Staffs** is classified as a **not pre-qualified for enhanced** company. This is because significantly more evidence or more evidence is required in relation to the following tests:

- performance commitments (wholesale water and household retail);
- wholesale cost assessment;
- average cost to serve (ACTS) adjustments (household retail);
- legacy adjustments (wholesale water);
- affordability (whole company test); and

Signed by:

Portfolio Lead

Clair Daniel

Accountable Lead

Andrew Beaver

Appendix 1: Pre-qualifying tests

Area	Household retail	Non-household retail	Wholesale water	Wholesale sewerage	Whole company
Outcomes	Consumer engagement and willingness to pay Performance commitments Outcome delivery incentives	Wales only: Consumer engagement and willingness to pay Performance commitments Outcome delivery incentive	Consumer engagement and willingness to pay Performance commitments Outcome delivery incentives	Consumer engagement and willingness to pay Performance commitments Outcome delivery incentives	
Costs	Retail cost allocation ACTS adjustment	Retail cost allocation Default tariffs	Wholesale cost assessment	Wholesale cost assessment	
Risk and reward	Retail net margins Risk analysis Level and allocation of risk	Retail net margins Risk analysis Level and allocation of risk (Wales only)	Rewards and returns Risk analysis Level and allocation of risk	Rewards and returns Risk analysis Level and allocation of risk	Rewards and returns Risk analysis
Affordability and financeability					Affordability Financeability
Other considerations			Performance in 2010-15	Performance in 2010-15	Board assurance

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
April 2014

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.