

## Dŵr Cymru: Test area assessment

| All company test area grades |  |                                   |                               |  |                          |                          |                              |                                   |
|------------------------------|--|-----------------------------------|-------------------------------|--|--------------------------|--------------------------|------------------------------|-----------------------------------|
| Engaging customers           | Addressing affordability and vulnerability | Delivering outcomes for customers | Securing long-term resilience | Targeted controls markets and innovation | Securing cost efficiency | Aligning risk and return | Accounting for past delivery | Securing confidence and assurance |
| B                            | B  | C                                 | C                             | C  | D                        | C                        | C                            | A                                 |

| Dŵr Cymru - test area results              |                         |   |     |                     |
|--|-------------------------|---|-----|---------------------|
| Test area                                  | Overall test area grade | Overall test area summary assessment and rationale  | TQ# | Test question grade |
| Engaging customers                         | B                       | <p>Overall the business plan demonstrates high quality with convincing evidence in the areas set out below, but it is not sufficiently ambitious or innovative to be considered exceptional.</p> <p>Dŵr Cymru provides sufficient evidence of a high quality approach in the following areas:</p> <ul style="list-style-type: none"> <li>ongoing engagement with customers since the last price review, incorporating tracker surveys and post interaction feedback into business as usual activities, using these ongoing insights to develop a customer sentiment map</li> <li>the company maintains a two-way dialogue with customers, demonstrating that it sought to inform customers, for example, through its education initiatives and behavioural change campaigns</li> <li>segmentation to understand the needs of different customers, conducting tailored research exercises with specific groups including vulnerable, hard-to-reach, future and “worst served” customers, demonstrably incorporating results in the business plan</li> <li>involving customers in strategic service design, customers having opportunities to challenge the company throughout the development of its business plan, and the company promoting customer behavioural change through several public awareness campaigns</li> <li>the company promoting community ownership of water, including collaboration with local groups to adopt and maintain paths around its reservoirs and supporting local environmental groups to help tackle invasive, non-native species or improve water bodies</li> <li>the company’s approach to understanding customer priorities and preferences for service levels and attitudes to resilience, including specific research with customers who have experienced repeated service failures</li> <li>the company explicitly incorporates the results of its targeted engagement through the introduction of a performance commitment to reduce the number of customers suffering from repeat service issues and explored long term and intergenerational issues with future customers by using its Youth Board.</li> </ul> <p>However, the business plan falls short of high quality with insufficient evidence, in the following areas:</p> <ul style="list-style-type: none"> <li>a wide range of qualitative methods are appropriately employed. However, the quantitative research evidence base used to inform performance commitments is much more limited and customer valuations are not always reflected in outcome delivery incentive (ODI) rates</li> <li>although the company uses information on comparative performance to set the context for customers and shows examples of the stimulus material used in its acceptability testing, evidence of more widespread use of comparative information is not found.</li> </ul> | EC1 | B                   |
| Addressing affordability and vulnerability | B                       | <p>Overall Dŵr Cymru’s business plan demonstrates high quality with convincing evidence that covers its approach to affordability and vulnerability because it proposes:</p> <ul style="list-style-type: none"> <li>the highest reach in the sector for its social tariff support, funding this through a combination of company money and customer cross-subsidies; and</li> </ul>   | AV1 | B                   |

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|-----------------------------------|-------------------------|---|-----|---------------------|
| Test area                         | Overall test area grade | Overall test area summary assessment and rationale  | TQ# | Test question grade |
|                                   |                         | <ul style="list-style-type: none"> <li>reducing bills by 5%. This was underpinned by high quality customer engagement on the level of bills and it secured high support for the affordability and acceptability of its plan.</li> </ul> <p>The business plan falls short of high quality in two areas because:</p> <ul style="list-style-type: none"> <li>While the company submitted some evidence of engagement with customers on long-term affordability, this was not of sufficient quality as it did not pertain directly to 2025-30. The company has proposed a bill increase of 2.7% over the period.</li> <li>The company submitted insufficient evidence on vulnerability. It proposed a relatively strong reach for its Priority Service Register but did not provide evidence on how it would deliver this improvement. Its engagement on vulnerability was low quality as it did not engage sufficiently with vulnerable customers.</li> </ul>  | AV2 | C                   |
|                                   |                         |   | AV3 | B                   |
|                                   |                         |   | AV4 | C                   |
|                                   |                         |   |     |                     |
| Delivering outcomes for customers | C                       | <p>Overall, across the delivering outcomes for customers test area the plan proposed by Dŵr Cymru falls short of high quality and the evidence it provides to support its performance commitments (PCs) and ODIs is insufficient or unconvincing in some areas.</p> <p>The plan demonstrates some aspects of high quality. The company proposes a package of performance commitments, which is reflective of its customers views and priorities. Additionally, the company's approach to protect customers from outperformance payments turning out to be higher than expected is sufficient.</p> <p>However, there are several key areas of concern where the business plan falls short of high quality:</p> <ul style="list-style-type: none"> <li>The company has not set a sufficiently stretching performance target for its internal sewer flooding PC.</li> <li>The company's approach to setting ODI types and ODI rates falls significantly short of high quality. The company proposes outperformance payments across a number of performance commitments that its customers wanted to be reputational only.</li> <li>The company's ODI rates are calculated based on a willingness to pay analysis conducted for sub-set of performance measures with management judgement being used to calculate some payment values.</li> </ul>   | OC1 | C                   |
|                                   |                         |   | OC2 | D                   |
|                                   |                         |   | OC3 | C                   |
| Securing long-term resilience     | C                       | <p>Overall, the plan falls short of high quality and the company has not provided sufficient and convincing evidence of securing long term resilience in certain areas.</p> <p>The plan provides sufficient evidence of a resilience maturity assessment, or 'Resilience Wheel', which considers the maturity of the company's systems and services. The company presents sufficient evidence that its resilience framework, aligns to the overall strategy 'Welsh Water 2050' and has assessed future trends that will have an impact on the resilience of the business. There is sufficient evidence that these future trends are prioritised from a longer list through collaboration and in consultation with customers. The planned mitigations presented by the company cover a wide range of options, including the wider promotion of SuDS and catchment management schemes, which are linked to strategic responses and therefore address identified risks.</p> <p>The plan generally provides sufficient evidence in terms of the process to assess financial resilience and that support the planned gearing level and targeted credit rating are consistent with long term financial resilience. However, there is insufficient or unconvincing evidence in one important respect because the results of financial stress tests do not include impacts on key financial ratios.</p> <p>We consider that the company plan does not provide sufficient and convincing evidence of a commitment to resilience in the round in the following areas:</p> <ul style="list-style-type: none"> <li>While the company provides an analysis of future trends impacting its business, this is at a high level and there is limited evidence of a risk assessment that quantifies risk exposure and fully considers system interactions and interdependencies.</li> <li>Much of the narrative related to risk assessment is qualitative and descriptive; there is limited evidence of a quantitative approach to the assessment of risks, where likelihood and impact are quantified against the company's systems and baseline mitigations.</li> <li>The resilience options presented in the plan are only justified by the high level assessment of future trends. There is therefore insufficient evidence to support the selection of the plan's proposals on resilience.</li> <li>Although the package of resilience related performance commitments is generally reflective of the company's challenges and customers' views, the bespoke resilience metrics are based on scorecards that are not sufficiently evidenced or presented in a transparent manner.</li> <li>The plan does not set out the results of the financial stress tests as key financial metrics and so there is insufficient evidence to determine the impacts of scenarios on key financial ratios relevant to the company's financial resilience.</li> </ul> | LR1 | C                   |
|                                   |                         |   | LR2 | B                   |

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| Test area                                 | Overall test area grade | Overall test area summary assessment and rationale  | TQ#  | Test question grade |
| Targeted controls, markets and Innovation | C                       | <p>Overall, despite some areas of high quality, Dŵr Cymru's plan falls short of high quality across the Targeted Controls, Markets and Innovation test area and evidence is insufficient and/or unconvincing in some areas.</p> <p>The company provides strong evidence that they satisfy most of the drivers necessary to have a strong innovation capability. The plan provides convincing evidence of strong leadership and supervisors' support to enable innovation within a non-hierarchical environment. Employees and other stakeholders are able to challenge the status quo to develop new approaches. The company provides strong evidence of partnership approaches in certain aspects of its plan. The plan demonstrates a high quality, ambitious and innovative approach to managing drainage and wastewater in an integrated and sustainable way, including using partnership working and markets to support effective delivery of outcomes. For RCV Allocation the information is complete.</p> <p>However, the plan provides insufficient evidence that innovation risks are considered and managed; and lacks evidence that ambitious ideas that go beyond the long-term goals would be considered. In relation to water resources and bioresources, the plan provides insufficient evidence of effective engagement with third parties to be considered high quality. Specifically, the company outlines its intention to use the market to address future sludge treatment capacity needs (which may be needed towards the end of 2020-25) but provides limited evidence that they have progressed discussions with neighbouring companies and other third parties. The company provides evidence that it has undertaken a detailed assessment of potential DPC projects as part of its investment programme, along with external advice and assurances. However, it falls short of high quality because the evidence to justify its decision to reject two schemes is unconvincing. In addition, the company's bid assessment framework is largely consistent with the key principles and best practice recommendations. However, the framework lacks sufficient detail on how the company would ensure the assessment is non-discriminatory and there is no reference to how they will manage sensitive information.</p> | CMI1 | B                   |
|   |                         |   | CMI2 | B                   |
|   |                         |   | CM3  | C                   |
|   |                         |   | CMI4 | C                   |
|   |                         |   | CMI5 | B                   |
|   |                         |   | CMI6 | C                   |
|   |                         |   | CMI7 | C                   |
| Securing cost efficiency                  | D                       | <p>Overall, Dŵr Cymru's plan falls significantly short of required quality in this area. We do not consider the company's projected costs for 2020-25 to be efficient. At the company level its costs are around 22% above our view of efficient costs.</p> <p>Its projected wholesale costs are 26% above our view of efficient costs in wholesale water and 16% above our view in wastewater. In retail, the company appears very inefficient, with costs that are almost 40% above our view of efficient costs. On base costs, the company's projected wholesale water costs are efficient, in line with our view of efficient costs. Its wholesale wastewater base costs are around 8% above our view of efficient costs. On enhancement, the company proposals appear inefficient. On the wastewater side, this is largely attributed to its high unit cost on growth-driven expenditure (ie new development costs, growth at sewage treatment works and costs to reduce flooding risk). On the water side, this is largely due to our rejection, or partial rejection, of the need to add to our view of enhancement costs for its high value cost claims, such as the water acceptability and the Cwm Taf Water Supply Strategy cost adjustment claims. The company's supply-demand balance unit costs are less efficient than the industry benchmark. The company does not forecast achieving upper quartile performance levels or greater than 15% leakage reduction, therefore, we make no associated allowance for leakage.</p> <p>The company proposes three high value cost claims. We consider that two of the claims did not require a special adjustment to our allowance because of the way we have made our modelled allowances. We make a partial allowance for the claim regarding reservoir safety. However the claims are high quality which gives the company a B for this test question.</p>  | CE1  | D                   |
|   |                         |   | CE2  | C                   |
|   |                         |   | CE3  | D                   |
|   |                         |   | CE4  | B                   |
| Aligning risk and return                  | C                       | <p>Despite some aspects of Dŵr Cymru's plan which are high quality, shortcomings in other aspects mean that it overall falls short of providing convincing and high quality evidence to support its approach in the area of aligning risk and return.</p> <p>The following areas of the plan are high quality:</p> <ul style="list-style-type: none"> <li>It is based on our Final Methodology 'early view' cost of capital and retail margins.</li> <li>There is convincing evidence to support the company's choice of PAYG rates.</li> </ul> <p>There are four main areas where the plan falls short of high quality. It does not provide sufficient and convincing evidence:</p> <ul style="list-style-type: none"> <li>to support the choice of target credit rating for the notional structure (BBB/Baa2/BBB Fitch/Moody's/S&amp;P), in the context of the investment programme and debt raising needs;</li> <li>that the level of the financial ratios are consistent with the target credit ratings for its actual structure;</li> </ul>  | RR1  | B                   |
|   |                         |   | RR2  | C                   |
|   |                         |   | RR3  | C                   |

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|                                   |                         | <ul style="list-style-type: none"> <li>to support its RCV run-off rates, in particular the assessment of asset lives; and</li> <li>to justify its proposed uncertainty mechanism for business rates.</li> </ul> <p>We also have concerns that the company's presentation of likely totex outcomes is weighted towards underperformance on a notional basis.</p>   | RR4  | C                   |   |
| Accounting for past delivery      | C                       | <p>Overall, Dŵr Cymru's business plan falls short of high quality in accounting for past delivery.</p> <p>In the round we have some concerns with the evidence for deliverability for the 2020-25 plan, in particular on costs, outcomes and customer complaints handling.</p> <p>The plan is high quality for deliverability in the following areas:</p> <ul style="list-style-type: none"> <li>Although we have some concerns with past performance in relation to major incidents, the company provides sufficient evidence that it has identified drivers of performance, learnt lessons and that the plan includes appropriate measures to deliver improved performance. We therefore do not have concerns with the evidence for deliverability of performance in relation to major incidents.</li> </ul> <p>The plan falls short of high quality for deliverability in the following areas:</p> <ul style="list-style-type: none"> <li>The company forecasts that it will overspend its cost allowance for 2015-20. The company provides insufficient evidence it has learnt lessons and identified improvement measures to address current cost performance. We therefore have some concerns with the evidence for deliverability of the planned costs.</li> <li>The company is proposing improvements in performance for supply interruptions and wastewater treatment compliance. The plan provides insufficient evidence that it includes appropriate measures to improve its performance for these performance commitments.</li> <li>The company is not yet meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at stage one and this proportion is declining (while it has reduced the number of complaints). The company provides insufficient evidence it understands the drivers of its performance and learned lessons. We therefore have some concerns with the evidence for deliverability of customer complaints handling performance.</li> </ul> <p>There is sufficient and convincing evidence for six out of eight PR14 reconciliation areas and insufficient evidence for land sales and residential retail. There is only a marginal difference (within 0.05% of 2019-20 revenue) between expected and proposed reconciliations. In the round, the sufficient and convincing evidence for the PR14 reconciliations is not sufficient to raise the accounting for past delivery test area score.</p> | PD1  | B                   |   |
|                                   |                         |   | <p>There is sufficient and convincing evidence for six out of eight PR14 reconciliation areas and insufficient evidence for land sales and residential retail. There is only a marginal difference (within 0.05% of 2019-20 revenue) between expected and proposed reconciliations. In the round, the sufficient and convincing evidence for the PR14 reconciliations is not sufficient to raise the accounting for past delivery test area score.</p> | PD2                 | C |
| Securing confidence and assurance | A                       | <p>Overall, Dŵr Cymru's business plan provides sufficient evidence to demonstrate high quality and ambition in the securing confidence and assurance test area.</p> <p>The company's Board provides statements of assurance in all of the requested areas to demonstrate that all the elements of its business plan add up to a plan that is high quality and deliverable. Most are supported by sufficient evidence of the Board's challenge and assurance process. This supports our overall confidence in the assurance of the plan and demonstrates Board ownership of the plan.</p> <p>The company's Board provides a compliant statement of assurance with sufficient supporting evidence to demonstrate that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term and the business plan will deliver – and that the Board will monitor delivery of – its outcomes.</p> <p>On evidence of a fair balance between customers and investors:</p> <ul style="list-style-type: none"> <li>On executive pay, the company demonstrates sufficient evidence of its intention to meet the expectations set out in the 'Putting the sector in balance' position statement, but we require a clear commitment to publish the final policy and evidence of how changes will be signalled to customers.</li> <li>On dividend policy, there is sufficient evidence of the company's intention to meet the expectations set out in the 'Putting the sector in balance' position statement, but we require a clear Board commitment to signal changes to stakeholders and a commitment to be transparent when determining dividends about how the dividend policy over 2020-25 takes account of obligations and commitments to customers.</li> <li>The company proposes a bespoke outperformance sharing mechanism ('Watershare') and donations to social tariffs and hardship funds which we assess could have a total value of £21.1m per year. The company's proposals for voluntary benefits sharing are ambitious and high quality in the context of its size as a company.</li> </ul>   | CA1  | B                   |   |
|                                   |                         |   |  | CA2                 | B |
|                                   |                         |   |  | CA3                 | A |
|                                   |                         |   |  | CA4                 | B |

| Dŵr Cymru - test area results |                         |  |     |                     |
|-------------------------------|-------------------------|--|-----|---------------------|
| Test area                     | Overall test area grade | Overall test area summary assessment and rationale   | TQ# | Test question grade |
|                               |                         | <ul style="list-style-type: none"> <li>The company does not forecast gearing above the 70% threshold during the 2020-25 period but it does not explicitly accept our default outperformance sharing mechanism.</li> <li>However the Board provides a partially-compliant statement of assurance that its plan will enable customers' confidence through high levels of engagement on its corporate and financial structures but there is sufficient evidence of transparency on its corporate and financial structures and how this relates to its long term resilience.</li> </ul> <p>In our assessment of the company in the 2018 Company Monitoring Framework (not including the elements related to the PR19 business plans) while the company has minor concerns in 2 areas, it exceeds expectations in 2 areas and meets expectations in 5 areas.</p> <p>Additionally the company provides sufficient and convincing evidence that overall, its business plan tables and the assurance and commentary provided are consistent, accurate and assured.</p> | CA5 | B                   |
|                               |                         |  | CA6 | B                   |