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Trust in water

PR19 initial assessment of plans: Overview of company categorisation

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1. Overview

Setting a new standard

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet needs of future customers and protect and improve the natural environment.

Our initial assessment of water companies' business plans for 2020-25 shows how the best companies across England and Wales are rising to these challenges.

Three companies – Severn Trent Water, South West Water and United Utilities – submitted plans that set a new standard for the sector. We have given these companies the green light, so they can get started on delivering their plans for customers.

We will be pushing the remaining companies to go further to achieve the new standard set by Severn Trent Water, South West Water and United Utilities.

Four companies – Thames Water, Southern Water, Affinity Water and Hafren Dyfrdwy – will need to do much more to address issues we have identified in their plans. The challenges facings each of these companies is different, and each is going through a period of change. These companies will need to improve and resubmit their business plans by 1 April this year.

Listening to customers

A record one and a half million customers shared their views as water companies developed their plans. Company customer challenge groups (CCGs) played a crucial role in scrutinising and reporting on the quality of each company's customer engagement and we thank them for this work.

Investing in the environment and for the future

Companies' plans set out their investment strategies for both the next five years and for the longer term. These include major new water resource supplies as well as advancing demand management, safeguarding the environment by reducing pollution incidents by 37% and improving 8,000km of rivers.

We are encouraging companies to prepare for future population growth and the impact of climate change by assessing the feasibility of a range of new water resource and transfer schemes. These include potential new water resources in south-east England and transfers of water from the north-west to the south-east of England.

Putting the sector in balance

In our statement on ‘Putting the sector in balance’ (‘Putting the sector in balance: position statement on PR19 business plans,’) we set out our expectations for:

- highly geared companies to explain how they will share financing gains with customers;
- all companies to demonstrate their financial resilience; and
- all companies to align executive pay and dividend policies with delivery for customers.

Several companies have offered voluntary sharing of benefits with customers. Most companies have taken steps to reflect our executive pay and dividend policy requirements. However, all companies need to do more in these areas to make sure the incentives for owners and executive teams will deliver the best outcomes for customers.

In December 2017, we set out our ‘early view’ of the cost of capital, the lowest allowed return on capital ever set by Ofwat. This reflects lower interest rates and returns in the wider economy. Twelve companies base their plans on our cost of capital. We will finalise our view of the allowed return of capital in draft and final determinations.

What happens next

We now move into the next phase of our price review. For Severn Trent Water, South West Water and United Utilities, this means early draft determinations for plans that are ready to implement. Other companies have until 1 April 2019 to revise their plans.

The most efficient companies set the standard for the costs that customers should pay for their water and wastewater service. Five companies – Hafren Dyfrdwy, Severn Trent Water, South West Water, United Utilities and Portsmouth Water – meet our stretching efficiency targets. We will intervene in other business plans to make sure all customers benefit from the efficiency of the top-performing companies.

We expect companies to continue their high level of engagement with customers as they implement the plans, demonstrating how they are fulfilling customers' expectations and working directly with customers to improve services.

In PR19 we set out four priority areas where we wanted to see standards improve across the board: affordability, customer service, resilience and innovation. Our requirements in these areas reflect the priorities and objectives set out in the UK Government and Welsh Government strategic policy statements.

Affordability

We welcome companies' plans to provide more support to customers struggling to pay their bills and those in vulnerable circumstances, with nearly all companies proposing to increase financial support for customers struggling to pay. The number of households on priority service registers (which are lists of customers in need) will rise significantly from 400,000 in 2017-18 to 2.3 million by 2024-25.

Fourteen companies propose to cut their bills in real terms, improving affordability for all. Some cuts are substantial – for example Northumbrian Water, South West Water, United Utilities and South Staffs Water plan to lower bills by more than 10% in real terms. We will be setting our view on the impact on bills later in the year.

Customer service

Companies' plans show both ambition and innovation in improving customer service and the environment. Proposed performance commitments are based on customer engagement, reflecting what customers want and need. We are pleased to see three companies – Anglian Water, South West Water and South East Water – push themselves to improve performance and set challenging financial incentives for what matters most to customers.

Across the industry, water companies have stepped up to our challenge to reduce leakage from their networks by around 15% over the next five years. Most companies plan additional improvements, with around a 40% reduction in supply interruptions and a 25% reduction in sewer flooding. However, there are gaps that need to be addressed; in particular we expect to see better performance on leakage by those companies with the highest leakage rates.

Resilience in the round

While all companies plan to improve the resilience of their services and systems, United Utilities and South West Water set the standard for other companies to reach. While there is good work by companies on individual aspects of resilience, we want to see resilience in the round more firmly embedded across the whole of each water companies' business.

Innovation

All companies' plans reflect the importance of innovation. While there are some examples of best practice, most companies have some way to go to show how innovation is supported and encouraged across the business. We are pleased to see the innovative range of customer engagement techniques used by companies as well as the measures companies have used to help those struggling to pay their bills or in vulnerable circumstances. United Utilities, Anglian Water, Severn Trent Water and Wessex Water demonstrate an effective approach to using and facilitating markets to promote catchment management, or the competitive procurement of resources and infrastructure.

Our decisions at a glance

Fast track	Severn Trent South West United Utilities	Plans ready to implement. Receive financial benefit, early decisions and early certainty.
Slow track	Anglian Dŵr Cymru Northumbrian Wessex Yorkshire Bristol Portsmouth South East South Staffs SES	Further work to do on plans.
Significant scrutiny	Affinity Hafren Dyfrdwy Southern Thames	Substantially rework and resubmit plans. Increased regulatory scrutiny.

2. Ofwat's price review: delivering more of what matters

Introduction

Customers tell us that water is everything. We all rely on it every day, as does the environment we depend on. Most customers cannot choose their water company. So water companies themselves do not face the competitive constraints that exist in other parts of the economy. As the economic regulator of the sector, it is part of our role to make sure customers of all water companies are protected.

Customers expect great service – at least a service comparable to what customers experience in other sectors in the economy. They expect water and wastewater services to be resilient to both short-term shocks, like harsher or drier weather, and long-term challenges, like population growth and climate change. And they expect those services to be affordable for all, including people struggling to pay their bills. They also expect their water company to protect and improve the environment. The only way water companies will achieve this, is to innovate and find new and better ways to deliver those services.

Our price review process makes sure that water companies will have incentives to make these improvements. Through our 2019 price review (PR19), we aim to enable, incentivise and challenge water companies to achieve that, so customers get more of what really matters to them.

The 2019 price review

A price review requires water companies, together with their customers, to create plans for the future that will deliver what customers want and need. We set the framework for these plans, and scrutinise and challenge them to make sure they meet customers' needs and companies' obligations. We asked companies to take a long-term approach to address interests of their current and future customers and ground their plans in longer term strategies. Company plans and our interventions, set the price, service and incentive packages for each water company for 2020-25. It is made up of the following four phases.

1. The initial assessment of business plans and categorisation of plans.
2. The early draft determinations for 'fast-track' companies.
3. The draft determinations for the other companies.
4. The final determinations.

In this document we set out the results of the first phase of PR19: the initial assessment of companies' business plans.

Our initial assessment of business plans

In our PR19 methodology, and our 'Putting the sector in balance' document, we set out a series of expectations and requirements for water company business plans, so companies really stretch themselves to deliver more for their customers, the environment and wider society in England and Wales. Our initial assessment tests business plans against these stretching expectations. Companies that meet our expectations will get early draft determinations, and financial and reputational benefits. Companies that do not meet our high expectations need to improve and resubmit their business plans.

We assess business plans against three overarching characteristics.

1. High quality – we expect each company's plan to:
    - be efficient, resilient and affordable;
    - include stretching performance commitments that really deliver for customers; and
    - give us confidence the company can and will deliver it.
2. Ambition – we expect companies to push the boundaries of efficiency and delivery for the sector, setting a new standard.
3. Innovation – we expect companies to develop and implement new ways of working including looking beyond their boundaries:
    - using new markets;
    - cooperating more effectively with third parties; and
    - moving from successful pilots to swiftly embed best practice from the water sector and other sectors into their day to day business.

Based on our assessment against our stretching expectations, we have put companies' business plans into three of four categories.

Exceptional

Many companies had elements of ambition and innovation. However, no company's business plan was sufficiently ambitious, innovative and high quality to be awarded 'exceptional status' and receive higher financial rewards than 'fast-track' companies.

Fast track

We give ‘fast-track’ status to high-quality plans but which are not ambitious or innovative enough to attain exceptional status where limited, minor or no intervention is needed to protect customers’ interests. The threshold for ‘fast track’ is high, and we assess the plans ‘in the round’. Fast-track companies will get early draft determinations, and financial and reputational benefits.

Three companies – **Severn Trent Water**, **South West Water** and **United Utilities** – measured up to our stretching expectations. These companies stretch themselves by:

- reducing their on-going expenditure;
- proposing to undertake additional investment to improve resilience and the environment;
- generally including stretching performance commitments that reflect customer priorities;
- proposing to cut bills by 5%, 14% and 11% respectively between 2020 and 2025 before allowing for inflation; and
- committing to a number of other improvements such as an increase in the number of customers on social tariffs, or benefiting from assistance on its priority services register.

In our assessment we identified some limited interventions in these plans to ensure customers interests are protected (and their ‘fast-track’ status was conditional on accepting these interventions). These companies have formally accepted the necessary interventions to their plans and therefore have ‘fast-track’ status. The companies will benefit from early draft determinations and receive a financial reward of £18 million for Severn Trent Water, £6.5 million for South West Water and £22 million for United Utilities. The differences reflect the relative size of the three companies.

Slow track

We give ‘slow-track’ status to plans that need material intervention to protect their customers’ interests.

We give ‘slow-track’ status to **Anglian Water**, **Dŵr Cymru**, **Northumbrian Water**, **Yorkshire Water**, **Wessex Water**, **Bristol Water**, **Portsmouth Water**, **SES Water**, **South East Water** and **South Staffs Water**. These companies have business plans that have elements of high quality but fall short of high quality in our in-the-round assessment. The companies must resubmit parts of their business plans and provide any additional evidence by 1 April 2019 to address our concerns.

Significant scrutiny

'Significant-scrutiny' status is for plans that fall well short of the required quality and need extensive material intervention to protect their customers' interests. Our assessment takes into account the number of areas of concern and the extent of the concerns.

We categorise four companies – **Affinity Water**, **Hafren Dyfrdwy**, **Southern Water** and **Thames Water** – as 'significant scrutiny'. Each of these companies faces different challenges, and each is going through a period of change. The categorisation of these plans recognises the challenges that these companies face and that they need to substantially rework their plans. We previously said we would consider allocating lower cost sharing rates and capped incentive payment rates to 'significant scrutiny' companies. We will consider whether this is still appropriate when we assess the resubmitted plans and may decide not to apply lower cost sharing rates or capped incentives payments, if companies effectively address the issues identified in our initial assessment of their plans.

Putting the sector in balance

In July 2018, we published our statement on 'Putting the sector in balance'. This document included targeted changes to our PR19 methodology to rebuild trust and confidence in the sector, through increasing the alignment of incentives for owners and executive teams, with those of customers. The changes to the methodology were targeted at increasing the incentives on owners and executive teams to improve outcomes for customers, increasing transparency and securing financial resilience through requiring companies to take steps to:

- ensure dividend policies reflect delivery for customers;
- ensure executive performance related pay aligns the interests of executives with those of customers;
- share the benefits of high gearing with customers;
- invited companies to propose voluntary sharing mechanism for other debt outperformance; and
- increase transparency on long-term financial resilience.

We find that, although good progress has been made, all companies have more to do to ensure their dividend and executive performance related pay policies will deliver the best outcomes for customers. We identify specific actions for all companies to improve in these areas.

The three fast track companies propose a range of voluntary sharing mechanisms including South West Water's Watershare Plus company share offer for customers, Severn Trent Water's community dividend and United Utilities funding of support for customers struggling to pay their bills.

Several companies do not provide sufficient evidence that all relevant factors were considered when demonstrating their long term assessment of financial resilience. Some companies have actions to adopt our default gearing benefit mechanism. This includes Thames Water and Yorkshire Water who did not accept our default mechanism or propose a suitable alternative, despite their high gearing.

Customer challenge groups and the contribution of other regulators

Customer challenge groups (CCGs) provide independent challenge to companies and independent assurance to us on:

- the quality of a company's customer engagement; and
- the extent to which the results of this engagement are driving decision making and are reflected in the companies' plans.

CCGs also report on whether there are any tensions between delivery of the proposed plan and compliance with statutory environmental and drinking water quality obligations.

We thank all members and chairs of CCGs for their important contribution to PR19.

We also welcome the contribution to PR19 made by other regulators and stakeholders such as Environment Agency (EA), Natural England (NE), Natural Resources Wales (NRW) and Drinking Water Inspectorate (DWI), as well as the Consumer Council for Water (CCW) as part of and via CCGs.

CCG reports welcome the contributions made by the other regulators and CCW, all of which is invaluable to CCG challenge of business plans.

The structure of the rest of this document

Chapter 3 shows how companies' business plans deliver for customers through:

- great customer service;
- affordable bills;
- resilience in the round; and
- innovation.

Chapter 3 also covers how the plans deliver for the environment.

Chapters 4, 5 and 6 set out at a high-level key points from our reasons for categorising the business plans into 'fast track', 'slow track' and 'significant scrutiny'.

Chapter 7 gives our next steps.

More information

There is more information about our decisions in the following documents, which are on our website.

Overview of company categorisation (this document)
PR19 initial assessment of plans: Summary of test area assessment setting out our overall approach to the initial assessment of business plans and our key findings by test area, together with supporting documents. Technical appendix 1: Delivering outcomes for customers Technical appendix 2: Securing cost efficiency Supplementary technical appendix: Econometric approach Supplementary technical appendix: Europe Economics Frontier shift and real price effects Supplementary technical appendix: KPMG totex and outcomes report Technical appendix 3: Aligning risk and return Technical appendix 4: Company specific adjustments to the cost of capital Bid assessment framework information note
For each water company: **PR19 initial assessment of plans: Company categorisation** setting out for our reasons for the category given to that company's business plan together with supporting documents (as required). Test area assessment Test question assessment Actions summary table Delivering outcomes for customers detailed actions

Accounting for past delivery detailed actions Securing confidence and assurance detailed actions Direct procurement for customers detailed actions
Template action tracker Common performance commitment outline for the Priority Service Register PR19 initial assessment of plans: Glossary PR19 price setting models map PR19 initial assessment of business plans: Past performance models PR19 initial assessment of business plans: Cost assessment models

3. How business plans deliver for customers

To address the future challenges the sector is facing, and the strategic policy statements of the UK and Welsh Governments, water companies need to deliver against the following four key themes for PR19.

1. Great customer service.
2. Affordable bills.
3. Resilience in the round.
4. Innovation.

Underpinning this, water companies need to act as responsible stewards of the natural environment. Perhaps more than any other sector, a healthy natural environment is a key ingredient for – and outcome of – the water sector. So we consider how companies' business plans deliver for customers through the above themes, and the environment.

Great customer service

Great customer service starts with an in-depth understanding of customer preferences and priorities. It involves customers in the development and delivery of services, and matches the experience customers get from the best companies in other sectors.

All companies are adopting the principles of good customer engagement that we set out in our 'Customer engagement policy statement and expectations for PR19'. The best performing companies, in particular Anglian Water and United Utilities, show ambition and innovation. Companies also propose performance commitments that reflect what their customers want and need. Some companies – Anglian Water, South West Water and South East Water – both push themselves to improve performance and set challenging financial incentives where it matters most to customers.

- Water leaks matter to customers. Across the industry, water companies have stepped up to our challenge to reduce leakage from their networks by around 15% over the next five years.
- The best companies are pushing themselves to improve their performance on common commitments like pollution incidents and water consumption per

person. However some companies are not challenging themselves in areas where their performance is weaker.

We asked companies to back up their performance commitments with financial incentives (or performance payments) based on what matters to customers.

- The best companies show a clear line of sight from customer research to priorities in their business plans, outcomes and associated financial incentives. Other companies provide little supporting evidence for incentives.
- Most companies are backing many of their outcome performance commitments with financial incentives. But some are limiting performance payments in their weaker areas or focusing their performance payments on their stronger areas.
- We are disappointed that companies are not proposing to protect customers from unduly high outperformance payments, for example by capping the maximum amount the company can receive.

All companies have at least one performance commitment to supporting customers in vulnerable circumstances. Most of them are demanding or stretching.

- All companies propose to include more households on their priority service registers, with a step change in membership forecast to increase from 400,000 to 2.3 million households.
- Companies could improve checks on customers already on the register, and work with partners to identify more customers in vulnerable situations.

We are introducing a new common performance commitment to ensure that all companies meet a high bar in increasing the coverage and maintaining their priority service register.

Our new customer experience measure (C-Mex) will compare water customers' experiences with that of other sectors. We are working with companies and other stakeholders to develop this measure so it is ready by April 2020.

We will introduce a new incentive focused on improving the developer services customer experience. Again, we are working with companies and other stakeholders to develop this measure so it is ready by April 2020.

Companies propose to take steps to align the incentives on their owners and executive with those of customers by developing proposals on dividend policy and executive pay for the 2020-25 period. However, all companies have more work to do in this area

Affordable bills

Water and wastewater services must be affordable to customers. This means affordable overall, in the long term and for people struggling – or at risk of struggling – to pay.

Companies show a step change in performance on affordability for 2020-25. The overall bill reduction across the sector, before inflation, is 5% between 2020 and 2025, with four companies – Northumbrian Water, South West Water, United Utilities and South Staffs Water – proposing real bill reductions of more than 10%.

Companies propose a broad range of approaches to help those struggling to pay their bills with instances of bill support increasing from 0.9 million to 1.5 million between 2020 and 2025. United Utilities in particular show ambition and innovation in this area. However some companies do not fully demonstrate that bills will be affordable beyond 2025, and have more work to do to understand long-term affordability issues.

- Fourteen companies propose to cut their average bill in real terms between 2020 and 2025. Three propose increases.
- Most companies are stretching their performance commitment on affordability, and the number of customers getting help with their bills is set to almost double.
- Several companies commit a share of their own future returns to address the challenge of affordability by putting their own money towards financial support schemes, such as social tariffs.

In December 2017, we gave our early view of the cost of capital. At the time this was the lowest in the water sector since privatisation. Most companies use this indicative cost of capital in their plans. This, on its own, will reduce bills by £15 to £25 per customer. We will set the cost of capital for each company in our decisions later in the year.

Five companies – Hafren Dyfrdwy, Severn Trent Water, South West Water, United Utilities and Portsmouth Water – put forward efficient on-going expenditure proposals. We are challenging other companies to reconsider their expenditure levels in light of efficiency benchmarks, which could provide further scope to reduce bills.

Resilience in the round

Customers expect reliable water and wastewater services that can avoid, cope with and recover from disruption. Water companies that deliver these services need to make the best short and long-term decisions about operations, maintenance and investment. This, in turn, means they need the right information, systems, processes, governance, capabilities and resilient balance sheets, cash flows and finances. They need to be resilient 'in the round'.

Overall, companies' approaches to identifying and mitigating risks to resilience is mixed. The best companies – South West Water and United Utilities – assess and prioritise a wide range of risks, provide a clear line of sight between risks they face and the measures that they propose, and include a range of solutions including those involving the natural environment and behavioural change.

However, companies typically:

- put forward commitments to improve day-to-day resilience and engage with their customers on resilience;
- describe well-established sets of systems and processes to identify and assess risks to resilience, but it is not always clear how they prioritise and mitigate those risks;
- develop better plans to make clean water services resilient, compared to wastewater and drainage challenges;
- do not use a systems-based approach to assessing risks to resilience;
- do not show they understand how much risk there is that customers will lose services;
- consider a range of options to mitigate operational risk but need to do more to make sure they choose the best options; and
- start to consider environmental resilience but do not make enough use of nature-based solutions to improve resilience beyond catchment management schemes (preventing pollution from getting into raw water sources rather than, for example, treating the water after contamination).

Many companies' proposals on resilience are backed up with improvements in performance commitments such as reductions in supply interruptions and improvements in asset health measures.

For financial resilience, most plans build on the evidence in companies' annual performance reports. Stronger plans include clear statements in their Board assurance statements that the company is financially resilient, which is supported by an assessment that is underpinned by internal risk assessment. However most assessments do not look beyond 2025.

Investing for the future

We are supportive of measures to maintain resilience. We are providing funding of £360 million to facilitate the development of strategic water resources options for the South and South East of England. This includes potential major new water resources in the South and South East of England and national transfers of water from the North West to the South East of England. This will enable companies to evaluate multiple options in more depth and to ensure that appropriate regional solutions can be taken forward in future investment plans. We expect companies to set out how they intend to work together, where necessary with companies not directly funded under this approach, to undertake more detailed feasibility and planning work.

Innovation

Innovation must be at the core of every company to deliver long-term resilience, great customer service and affordability. Innovation is essential if companies are going to meet future challenges like climate change and population growth.

We assess innovation across a company's business plan such as in its customer engagement, cost efficiency, use of markets and outcomes. We also consider whether companies have the right culture for innovation which enables them – through systems, processes and people – to deliver results for customers and the environment. We also look for examples of innovation.

The best performing companies – Anglian Water, Dŵr Cymru, Northumbrian Water, Severn Trent Water, United Utilities, Bristol Water, South East Water – show an embedded innovation culture and an ambitious approach to innovation capability. United Utilities shows the most embedded innovation culture, with an ambitious and sector-leading approach to innovation capability. It makes innovation a core value linked to every employee's annual appraisal/bonus process and has a good structure of support in place across the company.

Other companies do not give significant evidence of a culture of, nor capability for, innovation.

- Companies give evidence of senior leadership commitment and support for innovation but generally fail to show how staff are engaged or incentivised.
- Being innovative includes accepting a risk of failure, and learning from it. But companies' evidence about risk tolerance in relation to innovation is limited, and focuses on reducing the risk of failure.
- There is limited evidence of collaboration across companies on common innovation goals, and investment seems fragmented. For example, several companies are investing in partnerships with different universities. The sector may benefit from more co-ordination between water companies and the wider supply chain.

We are pleased to see innovation in other areas of company business plans such as in the range of customer engagement techniques used by companies and the measures companies have used to help those struggling to pay their bills or in vulnerable circumstances.

The best companies – Severn Trent Water, South West Water and United Utilities – commit to achieving significant cost efficiency improvements as well as stretching performance commitment targets, and so will need to innovate to deliver their business plans.

The environment

Water companies rely on the environment to provide water and wastewater services. They also need to provide services in a way that delivers environmental outcomes. We are pleased to see companies' commitment to protecting and enhancing the environment in terms of delivering against their environmental obligations, going further to increasingly work with nature in designing solutions – for example through more catchment management approaches – and moving ahead in terms of balancing supply and demand. Many companies' plans clearly set out customer support for a focus on the environment and reflect this in their business plans. While companies propose substantial improvements in environmental outcomes, we are pressing companies to go even further in certain areas, for example, on water efficiency to contribute towards the UK Government's 25 year environment plan and the Welsh Government's Water strategy for Wales.

Environmental outcomes

Across business plans submitted to us, water companies commit to:

- reducing leakage by around 15%;
- reducing the need to take water out of the environment in our most at-risk areas;
- increasing the number of catchment management schemes related to the Water Industry National Environment Programme (WINEP) in England by two-thirds as well as those related to the National Environment Programme (NEP) in Wales - companies' plans also include a significant number of extra catchment management schemes and investigations, not directly related to WINEP and NEP;
- improving 8,000km of river;
- reducing all pollution incidents collectively by 37% and the worst performing companies by up to 80%;
- committing to reductions in the amount of water used per customer, although we think that companies can go further;
- placing high importance on reducing flood risk, and supporting investment in these areas;
- ninety-six specific bespoke pledges ('performance commitments') on the environment, including for biodiversity and carbon reduction; and
- the development of natural capital accounts by a number of companies.

Markets can also promote better environmental outcomes and make better use of existing resources.

- Companies' business plans propose more market-based catchment solutions for the environment. Several are rolling out the En Trade platform developed by Wessex Water which uses markets to deliver environmental outcomes, like nitrogen reduction, at lower costs than conventional catchment management approaches.
- Companies are exploring water trading options but not enough, for example, to address the need to take less water from water-stressed environments.
- There are promising signs that bioresources trading between companies will increase, although current trading activity remains very limited.

As part of our resilience assessment, we also considered the extent to which companies' plans focus on ecosystem resilience (the ability of an ecosystem to maintain itself after damage). Plans need to go further in considering risks to environmental resilience.

Spending on the environment

- Water companies propose spending more than £5.3 billion on improving the environment between 2020 and 2025. This is nearly entirely related to WINEP and NEP. Of this total, £4.5 billion is related to wastewater obligations, particularly removing phosphorus (£2.2 billion).
- Also, around £0.6 billion of the £1.9 billion for maintaining supply-demand balance is directly related to the water environment. In particular reducing abstraction (taking water from a natural source) to improve river flow by finding alternative sources.
- Other spending may also improve the environment. For example, £0.6 billion for reducing sewer flooding risk and some of the £1.7 billion for improving resilience.
- We will be challenging water companies to ensure that this expenditure is efficient and delivers the most benefit to customers and the environment.

4. Fast-track companies

In this chapter, we set out the high-quality and ambitious or innovative elements of the plans from the three companies we award ‘fast-track’ status – and the changes the companies have agreed to make following our review.

‘Fast-track’ plans are high-quality plans where limited, minor or no intervention is needed to protect customers’ interests. The threshold to be placed in the fast track category is high and the assessment is made in the round.

We award fast track status to three companies: Severn Trent Water, South West Water and United Utilities. These companies provide high quality business plans across a wide range of areas, which other companies should learn from. Their plans:

- include both efficient and well justified cost proposals with generally stretching performance commitments that reflect customer priorities;
- include great customer engagement which is embedded throughout their business plans;
- include lower bills;
- increase assistance to those struggling to pay their bills or in vulnerable circumstances;
- use our early view of the cost of capital and provide good evidence that their plans are financeable; and
- include measures to better reflect customers’ interests in dividend policy and executive pay and voluntary benefit sharing with customers.

We identify high quality, ambitious and innovative elements from each of the fast-track plans below.

Severn Trent Water

Severn Trent Water’s plan is high quality across a range of areas including securing cost efficiency, engaging customers, addressing affordability and vulnerability, embedding innovation, accounting for past delivery and securing confidence and assurance.

The plan is generally efficient with respect to costs. On-going (base) expenditure is efficient and is 3% below our view of efficient costs. Severn Trent Water propose to reduce on-going expenditure compared to spend in recent years. Severn Trent Water is efficient on much of its wastewater enhancement expenditure.

Severn Trent Water's performance commitments generally reflect customer priorities and preferences. The company uses a range of customer engagement research techniques, including online community research and a range of quantitative research techniques. In many cases, they are best practice techniques.

Severn Trent Water rises to our challenge to make customers active participants. The company holds co-creative and deliberative workshops with customers looking at future issues. It engages with a range of customers, including people who don't respond straightaway or customers who have had a service failure.

Severn Trent Water propose a real bill reduction of 5% between 2020 and 2025, with high-quality and innovative customer engagement on affordability and acceptability of bills. It gets customer support for a large increase in assistance for customers struggling to pay. The company plans to register one in 20 customers on its priority services register by 2024-25. The company has a well-developed data sharing partnership with Western Power Distribution and uses several external data sources to understand the extent of different vulnerabilities in its area.

The company includes our early view on the cost of capital and retail margins in its plan. It also shows that the plan is financeable and the company is able to fund its activities. It proposes a high-quality, voluntary way of benefit sharing by contributing 1% of its profits to a 'community dividend'. The company plans to spend the dividend on projects to benefit customers and the community, and is also committing £10 million to a technical academy.

Severn Trent Water has many examples of best practice in innovation including a range of initiatives to ensure that its employees are empowered and continuously challenged to address business challenges now and in the future through various initiatives. These include 'The Challenge Cup', its internal crowd sourcing platform #BrightSparks, and its 'Open Innovation' ideas inbox. This is supported by its company-wide bonus scheme where all staff share in the success of the company.

Severn Trent Water has performed well in recent years, keeping its water and wastewater costs down, and meeting around 80% of its performance commitments linked to financial incentives. It puts forward suitable measures to address our concerns about the way it handles major incidents, for example following the 2018 freeze and thaw event.

To obtain fast track status the company accepted our proposed changes to a limited number of areas of its plan. These changes included:

- making small adjustments to enhancement costs to our view of efficient and justified costs;
- rebalancing the outcomes package towards its underperforming water business and reducing the scope for outperformance on sewer flooding;
- introducing financial penalties for some performance commitments; and
- reducing the amount of revenue recovered in this period, and increasing the revenue recovered in future periods.

South West Water

South West Water's plan is high quality across a range of areas including securing cost efficiency, delivering outcomes for customers, securing long-term resilience, engaging customers, and addressing affordability and vulnerability.

The plan is generally efficient with respect to costs. On-going expenditure is over 1% below our view of efficient expenditure. South West Water propose to reduce on-going expenditure compared to actual spend in recent years. The company is also efficient on elements of its water and wastewater enhancement expenditure, including phosphorus removal for wastewater and the installation of water meters.

The plan leads the sector with its outcome performance commitments and incentive package. The company proposes a stretching outcomes and incentives package, including for pollution incidents and incidents of sewer flooding inside customer premises – areas particularly important to customers.

South West Water proposes one of the best plans with respect to resilience and considers a range of options to mitigate the risks to resilience, including options for hard and soft infrastructure and for influencing consumer behaviour. The plan also provides environmental options under its 'Upstream and Downstream Thinking' initiatives.

The plan reflects high-quality customer engagement and participation. South West Water uses a range of customer engagement techniques, including postcard surveys, social media, and newspaper articles, as well as more innovative techniques like interactive online video. In many cases, they are best practice techniques.

The company has met our challenge that customers should be active participants. For example, with an innovative customer behaviour change scheme where customers earn points for saving water. The company has engaged with customers on a range of issues in the business plan, and longer-term issues including risk profiles and service expectations.

The plan has high-quality proposals on affordability. South West Water currently has the highest average bills in the country, in part reflecting historical investment in wastewater treatment to ensure beaches are clean. To address this, the company proposes a real bill reduction of 14% between 2020 and 2025, with high-quality, innovative customer engagement on affordability and acceptability of bills. Beyond 2025, the company projects the largest bill decrease in the sector (reducing bills by 12.5% between 2025 and 2030). The company also has a high-quality approach to helping people struggling to pay their bills. This includes getting customer support for a substantial increase in assistance for customers struggling to pay, with a significant increase in the number of customers getting its social tariff.

The company proposes to register 6.8% of customers on its priority services register by 2024-25, alongside a sector-leading commitment to update the register every two years. The company also plans to improve vulnerability support – for example, by introducing a WaterCare app specifically designed for vulnerable customers.

The company includes our early view on the cost of capital and retail margins in its plan. It also shows that the plan is financeable and the company is able to finance its activities. The company proposes an ambitious and voluntary way of sharing outperformance on the cost of debt with its customers, and an innovative scheme to offer shares in the company to its customers.

To obtain fast track status the company accepted our proposed changes to a limited number of areas of its plan. These include:

- committing to improve its Environment Agency Environmental Performance Assessment (EPA) rating by including a penalty only performance commitment to achieve a four star rating by 2024-25;
- increasing the stretch on some key performance targets; and
- small amendments to its cost proposals so that they reflected our view of efficient and justified costs.

United Utilities

United Utilities' plan is high quality across a range of areas including securing cost efficiency, innovation, securing long-term resilience, addressing affordability and vulnerability, engaging customers and taking account of past delivery.

The plan is generally efficient with respect to costs. Ongoing expenditure is only 3% above our view of efficient costs. The company proposes to substantially reduce on-going expenditure compared to actual spend in recent years. The company is also efficient on several areas of wastewater enhancement expenditure, including accommodating growth in wastewater services.

United Utilities shows the most embedded innovation culture, with an ambitious and sector-leading approach to innovation capability. It has made innovation a core value linked to every employee’s annual appraisal/bonus process and has a good structure of support in place across the company. United Utilities also evidence a balanced approach to risk tolerance, where it accepts that not all innovations succeed and that it can learn from failure.

Its plan includes ambitious, innovative and sector leading proposals on affordability and vulnerability. The company proposes a large bill reduction of 11% between 2020 and 2025 in real terms, with high customer acceptability. The company has an ambitious approach to helping people struggling to pay their bills. This includes:

- getting customer support for a large increase in assistance for customers struggling to pay;
- an increase of over 40% in the number of customers on its social tariff;
- a £71 million company contribution to social tariffs, which puts it among the leading companies in terms of voluntary benefit sharing with customers; and
- a sector-leading policy on providing flexible payment plans.

United Utilities’ plan reflects high-quality customer engagement and participation. It uses a range of research techniques, including online surveys, co-creation events and online panels tailored to the target audience. Some of its customer engagement activities are ambitious and innovative. For example, using behavioural economics techniques to get better insight into customers’ preferences, and using existing customer data in new ways.

United Utilities takes on our challenge that customers should be active participants. For example, it uses a range of techniques to involve customers in research on future products and campaigns (such as promoting water efficiency) – including at community events, in shopping centres, online and on social media – which helps the company get insight into its customers’ views, including on bill preferences. It has also engaged with a range of customers on longer-term issues and ongoing operations, including vulnerable customers.

United Utilities has a sector leading approach to resilience. The plan shows convincing evidence across operational, corporate and financial resilience. It shows a clear link between prioritised risks and measures to reduce risks to resilience. United Utilities' approach to incorporate the natural environment and ecosystem services through natural capital valuation is high quality and well evidenced with a number of initial pilot studies undertaken and plans for further roll out. Its assessment of financial resilience is supported by both Board and third party assurances. The company provides convincing evidence that it has assessed the risks to financial resilience that are specific to its circumstances.

United Utilities accepts our early view on the cost of capital and retail margins in its plan. It also shows that its plan is financeable and that the company is able to fund its activities. Its business plan shows the company has done a high-quality and thorough assessment of its financial resilience through to 2025.

United Utilities has generally performed well in recent years. It is currently meeting around three quarters of its performance commitments with a financial incentive. It is also meeting the Consumer Council for Water's 2020 household complaints target by resolving 95% of complaints at the first stage. While it has spent more than expected in the current period, it provides good evidence on how it is going to meet its stretching efficiency target and improve its performance on major incidents.

To obtain fast-track status the company has accepted our proposed changes to a limited number of areas of its plan. These include:

- small amendments to its cost proposals so that they reflected our view of efficient and justified costs;
- increasing the stretch on some key performance targets, including leakage where it is increasing the stretch from 15% to 20% reduction; and
- providing additional evidence to support its split of cost recovery in this period compared to future periods.

United Utilities propose a large 'direct procurement for customers' scheme to deliver significant improvement to resilience of Manchester water supplies. We welcome the direct procurement for customer proposals, however, further work is required on the scheme before approval. We propose to progress our assessment of the scheme outside of the fast-track process, given the significance of the issues.

5. Slow-track companies

In this chapter, we set out at a high-level key points from our reasons for categorising the business plans awarded 'slow-track' status.

'Slow-track' plans need material intervention to protect the interests of customers. All the companies in this category have business plans with both areas of high quality and areas that need more work. These companies tend to have either cost proposals or performance commitments that require further evidence of their efficiency or stretch, to demonstrate that they are in the customer interest. Often companies fall short on evidence in both, and in a number of other areas of their business plans. These companies need to improve and resubmit their business plans and to provide more evidence where needed by 1 April, before we make our draft determinations in July.

Key issues with slow-track companies' business plans

Water company	Key issues
Anglian Water	The company's plan is ambitious and innovative on customer engagement and uses a wide range of customer engagement techniques, with a clear line of sight between its research and financial incentives. The company's business plan also has high-quality elements, including: • its sector-leading proposal to increase the number of people on its priority services register to 15% of all customers; • stretching performance commitments; • ambitious proposals for the increased use of markets; and • good evidence of the deliverability of its cost and outcomes proposals. However its plan needs to be revised, in particular as it falls significantly short as: • its ongoing and enhancement costs are both more than 20% above our view of efficient and justified costs; and • it was not clear that the majority of the Board assurance statements are from the Board rather than the company. We also need more evidence to demonstrate financeability and to identify the link between its proposed measures to improve resilience and the risks that it faces.
Dŵr Cymru	The company puts forward an ambitious and high quality gain sharing proposal to contribute £85 million to support social tariffs and additional contributions to hardship funds, and also to share half of the financial incentives it receives for delivering performance commitments with customers. The company's business plan also includes high-quality elements, including: • two-way customer engagement; and

Water company	Key issues
	• plans to increase the number of customers helped through social tariffs to sector-leading levels. However its plan needs to be revised, in particular as: • it falls significantly short in that its overall cost is more than 20% above our view of efficient and justified costs; and • falls short about the level of stretch in its performance commitments, its evidence for its target credit ratings and its evidence on long-term resilience.
Northumbrian Water	The company's business plan has high-quality elements, including: • its customer engagement and participation, including its success in encouraging customers to participate in improving water quality; • proposing sector leading bill reductions; and • providing convincing evidence on financeability and its choice of revenue recovery between current and future periods. However its plan needs to be revised as it falls short including that: • its proposed financial incentives are too low to drive the performance that customers expect; • its overall costs are 15% above our view of efficient and justified costs; • it does not have a systems-based approach, or prioritise its risks to resilience; and • it does not have appropriate gearing outperformance sharing arrangements, despite forecasting gearing close to 70%.
Wessex Water	The company's business plan has high-quality elements, including: • using a wide range of customer engagement techniques; • good proposals to improve assistance to those struggling to pay their bills and in vulnerable circumstances; • ambitious and innovative use of markets, in particular through the extension of catchment management techniques; and • good evidence that it can deliver its plan. However its plan will need to be revised. We have substantial concerns as it is asking for a cost of capital 30 basis points higher than our early view without compelling supporting evidence, and there are inconsistencies in its evidence on financeability. In addition it falls short including that; • that its overall costs are more than 10% above our view of efficient and justified costs; • that it has not proposed stretching performance commitments in some areas; and • it does not provide enough evidence to support its outperformance payments.
Yorkshire Water	The company's business plan has high-quality elements, including: • using innovative techniques on customer engagement including the use of behavioural experiment techniques; • using catchment management and partnerships to provide water and wastewater services; and • good evidence of measures to ensure it can deliver its plan.

<table>
<tr><th>Water company</th><th>Key issues</th></tr>
<tr><td></td><td>However its plan will need to be revised as it falls short including that:
its overall cost is more than 15% above our view of efficient and justified costs;
it proposes bill increases and it offers low levels of help for customers struggling to pay;
it has relatively poor performance on asset health with insufficient evidence it will resolve these issues quickly;
it does not provide enough evidence to show it is targeting an appropriate credit rating; and
it does not have appropriate gearing outperformance sharing arrangements, despite forecasting gearing above 70%.</td></tr>
<tr><td>Bristol Water</td><td>The company's business plan has high-quality elements, including:
using a wide range of customer engagement techniques including a mixture of 'business as usual', traditional and innovative approaches; and
proposing stretching resilience performance commitments supporting by good customer engagement on resilience.
However its plan will need to be revised as it falls significantly short in that:
it does not provide enough evidence to show how it will improve its outcomes and customer complaints handling, given its past performance;
and it falls short, including that:
its overall costs are 15% above our view of efficient and justified costs;
it does not provide enough evidence to support some of its financial incentives on its performance commitments; and
it does not provide enough evidence for its proposed adjustment to the cost of capital, target credit rating or long-term resilience.</td></tr>
<tr><td>Portsmouth Water</td><td>The company has a high-quality plan on cost efficiency, with overall proposed costs 2% better than our view of efficient costs. It also provided sufficient evidence that an additional return is required to its cost of capital.
However its plan will need to be revised as it falls short, including that:
it does not propose stretching performance commitments in important areas and lacks evidence to support its proposed financial incentives;
we have concerns with the level of certain financial metrics underpinning the financeability assessment and insufficient evidence for target credit ratings;
its proposals on executive pay do not meet our expectations;
there is a lack of ambition in the proposed coverage of assistance on affordability and vulnerability;
it does not provide enough evidence to support its long-term resilience (including the risks associated with the Havant Thicket scheme); and
it does not provide enough evidence to support the robustness of its assessment of whether it should use direct procurement for customers to take forward its Havant Thicket reservoir proposals.</td></tr>
<tr><td>South East Water</td><td>The company's business plan has high-quality elements, including:
an innovative and sector leading approach to vulnerability;</td></tr>
</table>

Water company	Key issues
	• stretching performance commitments with good evidence to support its financial incentives; • good evidence of Board assurance of the plan; and • good evidence on innovation and best practice on collaboration. However its plan will need to be revised as it falls short, including that: • its overall cost is 20% above our view of efficient and justified costs; • it does not provide enough evidence to show it will be able to deliver its proposed performance commitments, given past performance; • it does not provide enough evidence for its targeted credit rating; and • it does not provide enough evidence to support the split of cost recovery between current and future customers.
South Staffs Water	The company's business plan has high-quality elements, including: • evidence of customer segmentation and participation in customer engagement; and • good evidence that it can deliver its plan. However its plan will need to be revised as it falls short, including that: • its overall costs are more than 15% above our view of efficient and justified costs; • its financial incentives may not reflect customer views; • it does not provide enough evidence of financial resilience and assessment of stress tests; • it does not provide enough evidence for its target credit rating and financeability; • it does not provide enough evidence to show that customer bills in the long term are consistent with customer preferences; and • it does not have appropriate gearing outperformance sharing arrangements, despite forecast gearing that exceeds 70%.
SES Water	The company's business plan has high-quality elements, including: • proposing a 5% bill reduction which its research shows results in bills that are acceptable and affordable to its customers; and • good evidence that it can deliver its plan. However its plan will need to be revised as it falls short, including that: • its overall costs are more than 20% above our view of efficient and justified costs; • only some of its Board assurance statements meet our expectations; • it does not provide enough evidence to support its financial incentives, particularly its incentive to improve asset health; • it does not provide enough evidence to support its proposed adjustment to the cost of capital; and • it does not provide enough evidence that the business plan is financeable.

6. Significant-scrutiny companies

In this chapter, we set out at a high-level key points from our reasons for categorising some companies' business plans as 'significant scrutiny'.

'Significant-scrutiny' plans fall well short of the required quality and need extensive material intervention to protect the interests of customers. Our assessment takes into account both the number of areas of concern and the extent of the concerns.

We give significant-scrutiny status to four companies: Hafren Dyfrdwy, Southern Water, Thames Water and Affinity Water. Each of the plans falls significantly short across a number of different areas. These plans also have few areas of high quality. Each of these companies faces different challenges and each is going through a period of change. We will therefore need to carefully assess these companies' revised plans and will work closely with them in the coming months to ensure that customers get a good deal.

These companies now need to substantially rework their plans by 1 April, before we make our draft determinations in July. We said we would allocate lower cost sharing rates and potentially capped incentive payment rates to 'significant-scrutiny' companies. We will relax this condition if we have clear evidence that the companies engage positively to address our concerns with their plan over the remainder of the price review process.

Hafren Dyfrdwy

Overall, the Hafren Dyfrdwy plan falls significantly short of the required quality. Hafren Dyfrdwy was formed in July 2018 to serve all Welsh customers previously served by Severn Trent Water and by Dee Valley Water. This followed Severn Trent Water's acquisition of Dee Valley Water. Hafren Dyfrdwy's Customer Challenge Group report states that this 'lead to a compressed timescale' for completing the business plan, and led to the company focusing its approach to customer engagement. In the 2014 price review we had a number of concerns with the Dee Valley Water plan including its cost efficiency. The categorisation of the plan as significant scrutiny recognises the scale of changes required to the plan and our desire to work closely with the company to address these issues.

The plan falls significantly short in several areas including outcomes, the balance of risk and return, resilience, past delivery, and affordability and vulnerability.

- Hafren Dyfrdwy is not committing to improve its performance enough for customers. We have concerns that its financial incentive rates are low and may not incentivise the company to improve its performance.
- Hafren Dyfrdwy does not give enough evidence of the steps it has taken to demonstrate its financeability or to show that its cost recovery rates are appropriate.
- There is a lack of evidence of customer support for its bills over the 2020-25 period, with the CCG raising concerns over the robustness of the testing. There is also little evidence on its forecast bills over the long term.
- Hafren Dyfrdwy has a low-quality approach to helping people struggling to pay their bills. It also has no plans to significantly increase the number of vulnerable customers on its priority services register.
- There is not enough evidence that Hafren Dyfrdwy's plan includes appropriate measures so that it can deliver its plan, given its recent performance. It proposes to become much more efficient but it does not sufficiently explain how. The company also does not give enough evidence to show it will be able to deliver all of the outcomes for customers it proposes or improve its customer complaints handling.
- It does not give enough evidence on long-term resilience, including whether:
  - it takes a systems-based approach;
  - it has carried out a baseline resilience maturity assessment;
  - it has prioritised risks within its plan; and
  - the company has robust financial risk mitigation and risk management given the reliance placed on the company's position in its group.

The plan also falls short in other areas, including:

- the limited range and quality of customer engagement techniques the company uses;
- the lack of a clear line of sight from customer preferences to performance commitments and financial incentives;
- the lack of evidence of engagement with third parties to secure water resources and on the use of catchment management and partnership working; and
- there is not enough evidence that the proposals on executive pay and dividend policy meet our expectations, and there is a lack of supporting evidence to Board assurance statements.

However, we also welcome some aspects of the plan. We are pleased that Hafren Dyfrdwy proposes to increase their efficiency, and substantially reduce their ongoing spending, which should help it deliver affordable bills for all customers. It also proposes stretching targets increasing the number of customers it supports who are struggling to pay their bills. Hafren Dyfrdwy carries out high quality engagement with customers on asset health and resilience in particular, and customers' preferences in these areas are reflected in its plan. It also shows that it has learnt from the opening of the business market and reflects these learnings in its plan.

We will work closely with Hafren Dyfrdwy over the coming months as it addresses our concerns.

Southern Water

Overall, Southern Water's plan falls significantly short of the required quality. In particular, we have concerns about its cost efficiency, resilience and past delivery. In its business plan, Southern Water acknowledges "historically poor performance and recent failings, which have fallen short of the expectations of our customers, regulators and other stakeholders". The company also acknowledges the substantial improvements required, launching a restructure in early 2017 and saying "we strive to fundamentally change the way we work both as a company and with our regulators". We acknowledge and welcome the work being undertaken by Southern Water to transform the way it delivers for customers. The categorisation of the plan as significant scrutiny recognises the scale of change required for customers and signals our desire to work with Southern Water to improve the way it operates. The areas where the plan falls significantly short include the following.

- Southern Water's overall costs are more than 20% above our view of efficient and justified costs. In particular its costs for enhancement are significantly higher than we would expect and it is much less efficient than its peers.
- We are concerned about the evidence on whether it can deliver some of the outcomes for customers. For example, Southern Water's leakage performance has been getting worse in the current period, but it proposes to meet our challenge to reduce leakage by 15% over the 2020-25 period, without providing sufficient detail on how it will achieve this. We are also concerned as to whether Southern Water has put in place suitable measures to be able to improve its performance on major incidents, for example following the issues identified in the 'Out in the cold' review of the 2018 freeze and thaw event.
- The company does not give enough evidence to show it can secure long-term resilience. For example, there is not enough evidence to show:
  - it takes a systems-based approach;
  - it has done a baseline resilience maturity assessment;
  - the level of detail on resilience of its wastewater business;
  - it understands the consequences and impacts of high-level risks to resilience;
  - specific schemes proposed as part of some of the transformational programmes; and

- it has considered all relevant factors associated with maintaining long-term financial resilience, despite its recent refinancing.

The plan also falls short in other areas, including:

- its performance commitments may not be sufficiently stretching;
- the lack of a clear line of sight between customer preferences and proposed performance commitments and financial incentives;
- the limited rationale in its assessment of direct procurement for customer schemes;
- the insufficient evidence to support the choice of the split between cost recovery in 2020-25 and in the long-term; and
- the company does not have a good track record in producing high quality data.

We are pleased to see some high quality elements within Southern Water's business plan. It provides evidence that it has addressed long-term affordability by engaging with customers on longer-term preferences and proposing to reduce bills even further in real terms by 2030. It is proposing to substantially reduce its retail costs to become one of the most efficient companies on retail expenditure. It shows that it has considered the lessons it can learn from the opening of the business market, for example about what business customers value. Its target that 90% of customers will be able to pay their water bills after receiving affordability assistance is ambitious and stretching. Southern Water also proposes to achieve a sector leading low level of per capita water consumption of 120 litres per person per day.

We will work closely with Southern Water over the coming months as it addresses our concerns with its plans.

Thames Water

Overall, Thames Water's plan falls significantly short of high quality. We welcome Thames Water's acknowledgement that "the reality that things haven't gone as well as planned in recent years" and says that it is making substantial changes. It states that "Thames is a very different company to 18 months ago". We support the proposed transformation of the way Thames Water delivers for customers. The categorisation of the plan as significant scrutiny acknowledges the scale of change required for customers and signals our desire to work with Thames Water to improve the way it operates. The plan falls significantly short in cost efficiency, resilience and past delivery.

- The company's overall costs are more than 20% above our view of efficient and justified costs. Its base costs have increased by more than 10% compared to current spending. Its enhancement costs are also high, and it is not efficient across a number of areas of water and wastewater enhancement expenditure.
- Thames Water's long-term resilience – particularly its operational resilience – leaves customers at higher risk of poor service, including pollution and loss of water supply. We have concerns over its understanding of its asset health, particularly as its asset health performance commitments do not propose enough improvement.
- Thames Water's plans for corporate systems for monitoring and managing risks to resilience give us concern. We are also not convinced it has considered all relevant factors associated with maintaining long-term financial resilience in the context of its high-level of gearing.
- Thames Water does not show that it can deliver the outcomes for customers it proposes. For example, there is not enough evidence that it has sufficient measures in place to meet its leakage reduction targets given its past performance. There is also a lack of evidence that it has put appropriate measures in place to deliver lower costs, improve performance on major incidents (for example following the 2018 freeze and thaw) and reduce customer complaints, given its poor past performance in these areas.

The plan also falls short in other areas, including:

- the company has not accepted our gearing benefit sharing proposal, despite forecasting gearing will be above 70%;
- its proposals for financial incentives may be too low to improve performance;
- its performance commitments are not stretching in some key areas including leakage, per capita consumption and supply interruptions, and as highlighted by the CCG may not reflect customer preferences;
- the business plan does not reflect customers' views in all areas;
- the plan has low bill affordability and acceptability with customers;
- the lack of evidence on the assessment of potential direct procurement for customer schemes;
- its evidence on the financeability of the company; and
- the lack of detail in its proposals on executive pay or dividend policy.

We are pleased to see elements of high quality in Thames Water's business plan. For example it has used a range of techniques to identify what customers want and need, and it proposes to substantially increase the number of people receiving help with bills through social tariffs. We were also pleased that Thames Water has developed ambitious and high-quality proposals to address the problem of properties which are not being billed for the water they are using. This will help keep bills affordable for customers.

We will work closely with Thames Water over the coming months as it addresses our concerns with its plans.

Affinity Water

Overall, Affinity Water's plan falls significantly short of high quality. Affinity Water's CCG report makes clear that it considers there were delays in the company's process for developing its business plan, which adversely affected the ability of the CCG to challenge the company and assure the plan. This in part reflects delays in the development of its draft water resource management plan. Our categorisation as significant scrutiny signals both the scale of the changes required and that we will work closely with the company over the coming months to address the issues.

The plan falls significantly short in resilience and aligning risk and return.

- Affinity Water's plan falls short on customer engagement on resilience. Given the risks of restrictions in the area, we are also concerned that its water resource management planning is not robust, and that it has not developed any bespoke resilience performance commitments.
- There are a range of issues with respect to the alignment of risk and return. There is unconvincing evidence to support the company's long-term view of inflation, which results in a higher real cost of capital than our early view. There are also inconsistencies in the financial metrics the company uses to assess financeability. In addition there is not enough evidence to:
    - support the proposed cost recovery rates; or
    - show that the resulting bill profile is supported by customer preferences.

The plan also falls short in other areas, including:

- its costs are more than 10% above our view of efficient and justified costs;
- the company failed to test customer acceptability and affordability of its final bill, which was higher than what was tested;
- there is insufficient stretch in its performance commitments with few bespoke performance commitments;
- there is insufficient evidence to support its financial incentive rates with few bespoke performance commitments;

- there is little evidence it has engaged with third parties on water resources and that it has put in place the right environment and processes to encourage innovation;
- there is little evidence that it has put in place appropriate measure to deliver cost efficiency and improve incident handling; and
- we identified a number of issues with the quality of its business plan data during our assessment.

We are pleased to see evidence that Affinity Water's business plan adopts the key requirements set out in the 'Putting the sector in balance' document. It is also supporting vulnerable customers by partnering with British Standards Institute to achieve 'inclusive services' standard before 2020 and by investing in an innovative platform which will, amongst other offerings, contact a nominated third party when a vulnerable customer is affected by a supply incident. It is proposing to substantially increase the number of customers it supports who are struggling to pay through its social tariff and a new company-funded hardship fund.

7. Next steps

The table below sets out the timelines and next steps for companies.

Table 1: Timelines and next steps for all companies

Company category	Next steps	Date
Fast-track companies	Companies must submit information, including: • updated business plan tables; and • evidence of completed actions.	10am on 11 February 2019
	Fast-track draft determinations to be published.	7am on 11 April 2019
	Fast-track companies' representations on draft determinations.	10am on 24 May 2019
Slow-track and significant-scrutiny companies	Companies must submit information, including: • a revised business plan; • updated business plan tables; • a completed Ofwat financial model; and • an actions tracker.	10am on 1 April 2019
	Slow-track and significant-scrutiny draft determinations to be published.	7am on 18 July 2019
	Slow-track and significant-scrutiny companies' representations on draft determinations.	10am on 30 August 2019
All companies	Final determinations to be published.	7am on 11 December 2019

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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