

January 2019

Trust in water

PR19 initial assessment of plans: Affinity Water company categorisation

About this document

In '[Delivering Water 2020: Our final methodology for the 2019 price review](#)' (the methodology) we said that we wanted all 17 regulated water and wastewater companies to produce high-quality, ambitious and innovative business plans, pushing forward the performance and efficiency of the sector for customers. To encourage this we developed the initial assessment of business plans (IAP) process. The IAP was designed to incentivise all companies to produce well-evidenced plans that reflect their customers' preferences and priorities and are efficient.

We explained that the IAP would:

- assess company business plans against nine key test areas that reflect our PR19 themes and the strategic policy statements of the UK and Welsh Governments and help make sure companies deliver for customers, the environment and wider society;
- assess company business plans against three key characteristics (quality, ambition, and innovation); and
- categorise company business plans into four categories (significant scrutiny, slow-track, fast-track, or exceptional).

Following the submission of companies' business plans on 3 September 2018, we have carried out an extensive and detailed review of these plans. This review has been carried out in accordance with our methodology. More details on our overall approach to the initial assessment of business plans and our key findings by test area are set out in the 'PR19 initial assessment of plans: Summary of test area assessment'. The results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation'. Our assessment is based on the information the company submitted to us as part of its business plans for the period 2020-25. The documents we have published are available on our [website](#).

This document sets out our assessment of Affinity Water's business plan submission under the IAP. It explains our assessment of the company plan in the round at an aggregate level and sets out a summary of our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the 'Affinity Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Affinity Water's categorisation

Our assessment of the plan

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 the needs of future customers and protect and improve the natural environment. We indicated in our PR19 methodology that the bar is high, and our Initial Assessment of Plans is the categorisation of company plans against those high expectations at this stage of the price review process. Where our expectations have not been fully met, we will continue to work closely with companies towards the draft and final determination stages.

Affinity Water's Customer Challenge Group (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.

We have placed Affinity Water in the significant scrutiny category. This categorisation is made after an in the round consideration of our assessment of Affinity Water's plan across the nine test areas and the level of intervention required in the plan to protect the interests of customers. Our grades for each test area are set out in Table 1 below.

While Affinity Water's plan falls significantly short in a number of areas, there are some high quality elements. For example, it adopts the key requirements set out in our 'Putting the sector in balance' document to improve corporate and financial governance. It provides sufficient evidence of an ambitious approach to protecting customers in vulnerable circumstances. It also proposes an ambitious approach to adding customers to its Priority Services Register. Its performance commitments for water supply interruptions will result in upper quartile performance and it forecasts the largest percentage reduction in per capita consumption of water across the industry.

Despite this we have concerns in a number of key areas of Affinity Water's plan. It falls significantly short on securing long-term resilience. There is insufficient evidence that it has engaged with its customers on options to improve the resilience

of its network. Its water resource management planning is not robust and it does not propose any bespoke resilience performance commitments, despite being in an area at risk of severe water restrictions.

It also falls significantly short on the balance of risk and return in its plan. There are inconsistencies in the financial metrics the company uses to assess its financeability. There is not enough evidence to support its view that its pay as you go (PAYG) and regulatory capital value (RCV) run-off rates are aligned to its customers' bill profile preferences. 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 and higher bills for customers.

It falls short in other areas of the plan, including:

- **cost efficiency** - its costs are around 12% above our view of efficient costs, driven by both higher base and enhancement costs;
- **affordability and vulnerability** - it has not tested customer acceptability and affordability of the final bill profile in its plan, which is higher than the bill profile it did test with its customers;
- **delivering outcomes** - it lacks stretching performance commitments, for example its leakage reduction target, with few bespoke performance commitments and insufficient evidence to support the financial incentive rates for its performance commitments;
- **targeted controls, markets and innovation** - there was a lack of evidence in relation to its approach to enabling company-wide innovation, its strategy for engaging with third parties to acquire new water resources as part of Ofwat's bilateral market reforms and whether it considered direct procurement for customers for any of the investments in its plan;
- **accounting for past delivery** - insufficient evidence that the plan includes appropriate measures to deliver improved performance on outcomes and customer complaints handling;
- **confidence and assurance** - its business plan data was low quality. We identified a number of data quality issues and some of the requested Board assurance statements were not provided in full; and

Given, the extent to which Affinity Water's plan falls significantly short of high quality with material interventions required to protect customers we have placed Affinity Water in the significant scrutiny category. We will work closely with the company over the coming months to address the issues identified to improve the overall quality of its plan and therefore the service it intends to provide to customers.

An overview of our assessment of the business plan in relation to the nine test areas and our grades for each test area are set out below. Our detailed assessment of the company's plan in relation to each of the test areas and test questions we published is set out in 'Affinity Water: Test area assessment' and 'Affinity Water: Test question assessment'.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	C
Addressing affordability and vulnerability	C
Delivering outcomes for customers	C
Securing long-term resilience	D
Targeted controls, markets and innovation	C
Securing cost efficiency	C
Aligning risk and return	D
Accounting for past delivery	C
Securing confidence and assurance	C

A = High quality, ambitious and innovative plan with evidence that overall is sufficient and convincing

B = High quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing

C = Concerns with the plan: Plan falls short of high quality and/or evidence is insufficient and/or unconvincing in some areas

D = Substantial concerns with the plan: Plan falls significantly short of required quality and/or little or no evidence, or no convincing evidence

Engaging customers

Overall, Affinity Water's business plan provides insufficient evidence to demonstrate a robust customer engagement approach.

The company's customer engagement is based on a multi-phase approach, using a wide range of methods. However there are limitations with its qualitative research, such as lack of detail of how insights from day to day customer contact data inform its plan. Its customer's service level preferences are not reflected in its plan as it relies on willingness to pay research for other companies' customer preferences.

The company provides insufficient evidence to demonstrate customer support for the acceptability and affordability of its business plan proposals. The company tested different bill impacts with customers to those in the final version of its business plan.

Addressing affordability and vulnerability

Overall, Affinity Water's plan falls short of high quality as it provides insufficient evidence of its approach to affordability and vulnerability.

It proposes a real bill increase of 3% between 2020-25, the second largest increase in the sector. The company's bill profile is higher than the bill profile it tested with its customers, which gives us little confidence that its customers accept the bill increase in its plan. In addition, it forecasts a 3% increase in bills from 2025-30 and provides no evidence that it has engaged with its customers on this.

The company does, however, demonstrate some aspects of high quality in its plan, such as proposing an ambitious approach to supporting customers in vulnerable circumstances. For example, it proposes an ambitious approach to adding customers to its Priority Services Register by 2024-25. It provides evidence of a high quality approach to using data to help customers in vulnerable situations. It also shows that it has a range of schemes available for customers with different needs and proposes a high quality approach to helping customers who struggle to pay their bills.

Delivering outcomes for customers

Affinity Water's business plan falls short of high quality in this test area. It provides insufficient or unconvincing evidence to explain its approach to setting its performance commitments and outcome delivery incentives.

The company proposes a limited package of performance commitments and only a small number of bespoke commitments. These bespoke commitments are also lacking in ambition. It is not proposing a bespoke resilience commitment despite the water resource challenges it faces and only proposes one asset health performance commitment. It proposes a leakage reduction target which is not sufficiently challenging when compared to its current performance and the rest of the sector.

The company has used evidence from other companies' customer research to support its outcome delivery incentive rates. It has not explained how this evidence was selected without bias so we have material concerns about its approach to bringing customer research findings together with other sources of customer data to inform these rates. The outperformance payments it proposes are not justified with insufficient customer engagement and valuation evidence.

The company demonstrates a high quality approach in some areas, as it sets a stretching performance target for water supply interruptions which will result in upper quartile performance by 2025. It has also forecast the largest percentage reduction in per capita consumption of water across the industry.

Securing long-term resilience

Affinity Water's plan falls significantly short in this test area. In some areas there is little or no evidence that convincingly demonstrates a commitment to resilience in the round.

There is little to no convincing evidence to link the identified resilience challenges faced by the company to the outcomes package it proposes.

The company provides insufficient evidence to demonstrate an integrated and systems-based approach to resilience. The evidence in its plan lacks depth and scope and there is limited evidence that customers have been consulted appropriately on options to improve resilience. The company lacks a robust water resource management plan that supports its long-term resilience strategy. This is of concern as the company has identified a number of customers who are at risk of severe water restrictions. We anticipate improvements as the company is continuing to develop its water resource management plan. We will consider whether to take changes into account at the draft determination and final determination stages of PR19.

The company is highly geared, and proposes to reduce its gearing to around 70%, but there is no evidence to demonstrate how or when this will be achieved. However, the company has not presented the results of its company specific scenarios in terms of their impacts on key financial ratios.

Targeted controls, markets and innovation

Affinity Water's plan falls short of high quality across the target controls, markets and innovation test area with insufficient and unconvincing evidence in some areas.

The company provides limited evidence to demonstrate its approach to enabling innovation company-wide and it is unclear what the company is already doing in this space. It provides limited evidence that it is engaging with third party providers for supply and demand solutions to help address the water deficit it is forecasting in the short term. Its plan does not include a strategy for engaging with third parties to acquire new water resources as part of Ofwat's bilateral market reforms, and related data is incorrect.

The company's plan provides no evidence that it has considered direct procurement for customers for any of the investments in its plan. It does reference the Abingdon reservoir scheme, however it is excluded from the assessment as this scheme is being developed and led by Thames Water.

Securing cost efficiency

Overall we do not consider Affinity Water's costs to be efficient. At the company level its costs are 12% above our view of efficient costs. Its wholesale water costs are 11% above and its retail costs are 22% above our view of efficient costs.

Affinity Water proposes four cost adjustment claims. Three of these are not of high quality and one of them is of sufficient quality.

Aligning risk and return

Overall Affinity Water's plan falls significantly short in all areas of our aligning risk and return assessment. It provides little or, in some cases, no convincing evidence to support the most material aspects of this test area.

The company provides unconvincing evidence for its alternative long-term Retail Prices index (RPI) assumption, which is lower than our 'early view' and results in a higher cost of capital in its plan and higher bills for customers during PR19.

The financial metrics the company uses to support its Board's assessment of financeability are substantially different to the metrics forecast in the PR19 financial model. There is insufficient evidence from the company to reconcile the differences. Although the PAYG and RCV run-off rates may be appropriate, the company provides insufficient evidence that the rates are supported by the operational and capital costs it faces.

There is insufficient evidence that its final bill profile is aligned to customer preferences. The bill profile in its plan is different to the one that it used in its customer acceptability testing and the customer challenge group did not have sufficient time to review or challenge the revised profile.

The company provides insufficient evidence to explain its risk mitigation measure assumptions in its Return on Regulated Equity (RORE) assessment for the notional company. There is insufficient evidence that one of its proposed uncertainty mechanisms is required. We need further evidence from the company that its second proposed uncertainty mechanism will still be uncertain at the time of draft and final determinations.

Accounting for past delivery

Overall, Affinity Water's plan falls short of high quality in accounting for past delivery. In the round we have some concerns with the evidence for deliverability of its 2020-25 plan, in particular in relation to its outcomes and customer complaints handling.

The company's plan provides sufficient evidence that it has measures in place to deliver planned improvements on costs and major incidents.

While the company has good performance on outcomes, it does not provide enough evidence that it understands the drivers of its current performance and that the plan includes appropriate measures to deliver planned improvements in outcome performance.

The company is not yet meeting CCWater's 2020 target of resolving household customer complaints, although the number of complaints received is below average for the sector. The plan does not provide enough evidence that the company understands the drivers of its performance, or that it includes appropriate measures to improve its performance.

Securing confidence and assurance

Overall, Affinity Water's plan falls short of high quality in the securing confidence and assurance test area.

The company provides evidence of high quality in meeting the expectations in our 'Putting the sector in balance' position paper in terms of its proposals on gearing outperformance benefits sharing, executive pay and dividend policy. It also proposes a high quality package of voluntary benefit sharing in terms of company contributions to social tariffs and its hardship fund.

However the plan falls short of high quality in terms of its data and Board assurance statements. We identified a number of issues with the company's business plan data. While the company's Board provides the majority of the requested assurance statements, a number of statements are not provided in full.

2. Funding to facilitate the development of strategic water resources

We are providing funding to facilitate the development of strategic water resources options for the south and south-east of England 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 to undertake more detailed feasibility and planning work.

£70.9 million of this funding will go to Affinity Water.

3. Next steps and overall timeline

Actions for the company are set out in 'Affinity Water: Actions summary table'.

The next part of the process will be the draft determination, followed by the final determination, as set out in the table below.

Date	Milestone
1 April 2019	Revised business plans submitted
18 July 2019	Draft determinations published
30 August 2019	Representations on draft determinations due
11 December 2019	Final determinations published
1 April 2020	Price controls for 2020 – 2025 come into effect

Appendices

The appendices below can find be found on our [website](#).

- Affinity Water: Test area assessment
- Affinity Water: Test question assessment
- Affinity Water: Actions summary table
 - Affinity Water: Delivering outcomes for customers detailed actions
 - Affinity Water: Accounting for past delivery detailed actions
 - Affinity Water: Securing confidence and assurance detailed actions

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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