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Trust in water

# **PR19 initial assessment of plans: Dŵr Cymru 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 Dŵr Cymru's business plan submission under the IAP. It explains our assessment of the company's plan in the round at an aggregate level and our assessment across each of the nine test areas as set out in our methodology.

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

## 1. Overview of Dŵr Cymru 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.

We have placed Dŵr Cymru in the slow track category. This categorisation is made after an in the round consideration of our assessment of Dŵr Cymru's business plan across the nine test areas and the overall level of intervention in the plan required to protect the interests of customers. Our grades for each of the test areas are set out in Table 1 below

Dŵr Cymru's business plan stands out by its ambitious and high quality proposals for a bespoke outperformance sharing mechanism. It proposes to contribute £85 million to support social tariffs, as well as additional contributions to hardship funds. It also proposes to share half of its performance commitment rewards with customers. The company has taken positive steps to meet our expectations on putting the sector in balance, including on performance related executive pay. This is reflected in its sector leading score in the confidence and assurance test area.

The company also performs well in the following test areas:

- **Engaging customers:** It has established ongoing customer engagement and maintains a two-way transparent customer dialogue, uses a range of research methods, and adopts a tailored and segmented engagement approach. It also involves customers in strategic service design and demonstrates a high quality approach to understanding customer priorities and preferences for service levels.
- **Affordability and vulnerability:** It proposes social tariff support with the broadest customer reach in the sector, funding this through a combination of company money and customer cross-subsidies. It also proposes bill reductions of 5%, underpinned by high quality customer engagement on the

level of bills and securing high support for the affordability and acceptability of its plan.

However, in contrast to these high quality elements of the plan, we have substantial concerns around Dŵr Cymru's **cost efficiency**, as its company level costs are around 22% above our view of efficient costs.

We also have concerns around other aspects of the plan, including the following:

- **Delivering outcomes:** A number of its performance commitments are not sufficiently stretching, including most common performance commitments. It also goes against its customers' preferences on some performance commitments where it proposes outperformance payments.
- **Risk and return:** It does not fully justify its choice of target credit ratings, or provide sufficient evidence to support its proposed Regulatory Capital Value (RCV) run off rates or its proposed uncertainty mechanism for business rates.
- **Securing long-term resilience:** Its analysis of future trends impacting the business is high level and there is limited evidence of a risk assessment that quantifies risk exposure. Its financial stress test results also do not detail impacts on key financial ratios.
- **Controls, markets and innovation:** It presents limited evidence of third party collaboration on water resource trading or bioresource development and does not justify its decision to reject two direct procurement for customers (DPC) schemes.
- **Accounting for past delivery:** It forecasts it will overspend cost allowances for 2015-20. The company provides insufficient evidence it has learnt lessons and identified improvement measures to address current cost performance.

Given the scale and scope of these concerns, we consider that the plan requires a level of material intervention to protect customer interests. We are therefore categorising the plan as slow track.

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 test areas is provided in 'Dŵr Cymru: Test area assessment' and 'Dŵr Cymru: Test question assessment'.

**Table 1: Overall test area assessments**

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

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

An overview of our assessment in the nine test areas is set out below.

### Engaging customers

The company's adopts a high quality approach in this area. It demonstrates ongoing customer engagement since the last price review, embedding tracker surveys and feedback into business as usual. It engages in a two-way transparent customer dialogue to develop its 2020-25 business plan, using of a range of research methods and a segmented approach to capture the views of specific groups including hard to reach and 'worst served'. It also involves customers in strategic service design and demonstrates a high quality approach to understanding customer priorities and preferences for service levels. However, the quantitative evidence base that it uses to inform performance commitments is limited and customer valuations is not always reflected in outcome delivery incentives rates. In addition, while it uses comparative performance information to set context, it does not make more widespread use of this data.

### Addressing affordability and vulnerability

The company's approach to affordability and vulnerability is of high quality. It proposes to cut bills by 5%, underpinned by high quality customer engagement on the level of bills and securing high support for the affordability and acceptability of its plan. In addition, its proposals for social tariff support demonstrate the broadest customer reach in the sector, funding this through a combination of company money

and customer cross-subsidies. However, the company's engagement on long-term affordability is not of high quality as it did not relate directly to the 2025-2030 period. In addition, although the company proposes a relatively strong reach for its Priority Services Register, it has not provided sufficient detail on how it will effectively achieve these targets.

### **Delivering outcomes for customers**

The company's approach toward delivering outcomes for customers falls short of high quality. While it proposes a package of performance commitments that reflect customer views and provides confidence that customers will be protected if outperformance payments are greater than expected, we have concerns in a number of areas. In particular, its internal sewer flooding targets are not sufficiently stretching. In addition, despite customer engagement indicating that the outcome delivery incentives for certain performance commitments should be reputational only, it proposes outperformance payments in these areas. Its top-down approach to setting outcome delivery incentives also falls significantly short of our expectations as it is based on analysis completed for a limited number of Performance Commitments.

### **Securing long-term resilience**

The company's plan falls short of high quality on long-term resilience in the round. It provides evidence of a resilience maturity assessment, aligned to its overall strategy, alongside proposed options and mitigations driven by future trends. However, its analysis of future trends impacting the business is high level and it does not present a comprehensive risk assessment, with much of the narrative being qualitative in nature. It justifies its resilience options by reference to the high level assessment of future trends and does not make a strong case for its proposals on resilience. In addition, the bespoke resilience metrics it proposes are based on scorecards that are not sufficiently evidenced or presented in a transparent way. While it presents evidence of financial resilience, with a gearing level and target credit rating that are consistent with long-term financial resilience, the results of its financial stress tests do not include impacts on key financial ratios.

### **Targeted controls, markets and innovation**

The company's performance in this area is mixed but falls short of our expectations overall. It demonstrates that it has most of the conditions to support innovation, with strong leadership and supervisor support allowing employees to challenge the status

quo. It also presents evidence of partnership working particularly in its innovative approach to managing drainage and wastewater.

However, the plan provides insufficient evidence of effective engagement with third parties on water resources and bioresources. The company outlines its intention to use the market to address future sludge treatment capacity needs but provides limited evidence that it has progressed discussions with third parties. While the company demonstrates that it has undertaken a detailed assessment of potential DPC projects, it does not effectively justify its decision to reject two schemes. In addition, its bid assessment framework lacks detail on how it would assure non-discrimination or how it would manage sensitive information.

### **Securing cost efficiency**

The company falls significantly short in relation to cost efficiency. Its company level costs are around 22% above our view of efficient costs. While its projected wholesale water base costs are efficient, its wholesale wastewater base costs are around 8% above our view of efficient costs and its enhancement costs are also inefficient. The inefficiency in wastewater costs is largely due to high unit costs associated with new developments, growth at sewage treatment works and reducing flooding risk.

Dŵr Cymru proposes three high value cost claims which are of high quality. However, we consider that two of the claims do not require a special adjustment to our modelled allowance.

### **Aligning risk and return**

The company's plan falls short of high quality on risk and return. While it bases its plan on our 'early view' cost of capital and retail margins and demonstrates that its pay as you go (PAYG) rates are appropriate, it presents insufficient evidence in key areas. In particular, it does not fully justify its choice of target credit ratings for the notional structure or sufficiently demonstrate that financial ratios are consistent with target credit ratings for its actual structure. It also does not provide sufficient evidence to support its proposed RCV run off rates or justify its proposed business rates uncertainty mechanism. In its assessment of risk management and risk mitigation, we also have concerns that it presents totex outcomes with a skew toward underperformance.

### **Accounting for past delivery**

The company's plan falls short of high quality in relation to evidence to demonstrate deliverability of the 2020-25 plan. In particular, it forecasts that it will overspend cost allowances for 2015-20 and does not include evidence of appropriate measures to address current cost performance. The company proposes stretching performance commitments for supply interruptions and wastewater treatment compliance but the plan provides insufficient evidence that it includes appropriate measures to improve its performance for these performance commitments. It is not yet meeting CCWater's 2020 household customer complaints target and provides insufficient evidence it understands the drivers of its performance and learned lessons. It presents good evidence for deliverability in relation to major incidents as it identifies performance drivers, lessons learnt and that the plan includes appropriate measures to improve performance.

### **Securing confidence and assurance**

Dŵr Cymru is the only company in the sector to demonstrate ambition and high quality in the securing confidence and assurance test area. We consider this element of its business plan to be ambitious due to its proposed package of voluntary sharing, which includes donations to social tariffs (£85 million) as well as additional contributions to hardship funds and a mechanism which will return outperformance on outcome delivery incentive rewards to customers. We assess these elements could, in combination, have a customer value of £21.1 million per year. A number of other elements of the plan are high quality including the proposals on performance related executive pay. The Board also provides the vast majority of requested assurance statements which supports our confidence in the Board's ownership of the plan.

## 2. Next steps and overall timeline

Actions for the company are set out in 'Dŵr Cymru: 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
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](#).

- Dŵr Cymru: Test area assessment
- Dŵr Cymru: Test question assessment
- Dŵr Cymru: Actions summary table
  - Dŵr Cymru: Delivering outcomes for customers detailed actions
  - Dŵr Cymru: Accounting for past delivery detailed actions
  - Dŵr Cymru: Securing confidence and assurance detailed actions
  - Dŵr Cymru: Direct procurement for customers detailed actions

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Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

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