

January 2019

Trust in water

PR19 initial assessment of plans: Hafren Dyfrdwy 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. Our assessment approach for each of the nine test areas is set out in the 'PR19 initial assessment of plans: Summary of test area assessment' document. The overall results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation' document. 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 Hafren Dyfrdwy'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 'Hafren Dyfrdwy: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Hafren Dyfrdwy 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.

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. As such, we recognise that the company continues to go through a period of change.

We have placed Hafren Dyfrdwy in the significant scrutiny category. This categorisation is made after an in the round consideration of our assessment of Hafren Dyfrdwy'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.

It is important to highlight that Hafren Dyfrdwy demonstrates sector-leading performance on costs, which constitutes a positive turnaround from PR14 where we had a number of concerns with the Dee Valley Water plan including on its cost efficiency. Its proposed total expenditure for the period 2020-25 is 3% below our view of efficient costs. This cost reduction will have a substantial benefit to customers, and help deliver affordable bills. It has conducted 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 learned lessons from the opening of the business retail market to competition in England.

However, we have substantial concerns related to the following areas of the plan.

- **Outcome delivery:** Its performance commitments are not sufficiently stretching and it has proposed outcome delivery incentive rates that are low compared to peers which may not effectively incentivise the company to improve performance.
- **Aligning risk and return:** It does not provide evidence that its proposed pay as you go (PAYG) and regulatory capital value (RCV) run-off rates are appropriate and aligned with customer preferences. It also fails to set out the Board process or assurance to demonstrate the plan is financeable.
- **Affordability and vulnerability:** It does not demonstrate customer support for its final bills over the 2020-25 period and it is unclear what the average bill over the period is.
- **Accounting for past delivery:** It proposes significant improvements in cost efficiency but does not provide sufficient evidence on the deliverability of this.
- **Securing long-term resilience:** It provides limited evidence of resilience in the round. In particular, it does not adopt a systems-based approach or identify the link between mitigations, prioritised risks and performance commitments.

We also have concerns in the following areas of the plan.

- **Engaging customers:** It uses a limited range of customer engagement techniques and its overall approach falls short of high quality.
- **Controls, markets and innovation:** It does not demonstrate engagement with third parties to assess water resource options. In addition, it has not established processes to encourage innovation.
- **Securing confidence and assurance:** It does not demonstrate that its proposals on executive pay and dividend policy meet our expectations.

Given the scale and scope of these concerns, we consider that the plan will require extensive material intervention to protect customer interests. We will work closely with Hafren Dyfrdwy over the coming months as it addresses our concerns, and the company will need to improve and resubmit their business plans by 1 April this year.

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 'Hafren Dyfrdwy: Test area assessment' and 'Hafren Dyfrdwy: Test question assessment'.

Table 1: Overall test area assessments

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

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

Engaging customers

The company falls short of high quality in this test area though there are positive elements in its plan. The company makes efforts to engage with a wide range of customers, and in particular the company's project to engage customers on asset health and resilience appears to have been well-designed, with evidence showing bill profiles have been adjusted following customer engagement. While the company also presents acceptability and willingness to pay research, the evidence it provides in a number of areas is insufficient. It does not demonstrate the use of a range of research techniques and only uses a single piece of research to derive customer valuations for use in outcome delivery incentive rates. It does not present evidence that it has established a systematic, ongoing approach to customer engagement. In this respect, while its Pipe Up survey records day to day customer opinions about interactions with the company, we find no evidence of company insight from this data, or how it informs the plan.

We found insufficient specific examples of the company adopting the four themes of customer participation detailed in Ofwat's customer engagement best practice 'Tapped In' report. While the company has engaged a wide range of customers, it does not demonstrate engagement with a wide enough range of customers in vulnerable circumstances, particularly those that can afford their bills but have other needs that make them vulnerable. The Customer Challenge Group (CCG) also expresses concerns that the company did not complete acceptability research in both its geographic regions.

In addition, although not part of our assessment, we are disappointed that the company did not fulfil its commitment to engage the CCG on its treatment of savings accrued as a result of the adoption of the Legacy Alternative project in AMP6.

Addressing affordability and vulnerability

Hafren Dyfrdwy's plan falls well short in this area. It has not tested the final bill for 2020-25 with customers and is higher in one of the company's areas than the bill shown to customers. It provides very little information on its long-term bill projections. Its estimate for Priority Services Register (PSR) membership is that it will reach 1.1% by 2024-25 which is relatively low compared to the rest of the sector. It also proposes a performance commitment related to support for customers in vulnerable circumstances that reflects business-as-usual activities for the sector and is therefore not stretching. Its approach to helping people that will struggle to pay their bills is poor and it does not set out how it will promote affordability schemes. Its approach to engaging customers in all of these areas is of low quality.

Delivering outcomes for customers

Hafren Dyfrdwy's plan falls well short in this area. It has not proposed stretching targets for key outcomes including per capita consumption and supply interruptions, and does not present any data on the performance commitment related to unplanned water outages. It also does not demonstrate an objective and consistent approach to triangulation of customer valuations. Its proposed outcome delivery incentive package is much smaller than the indicative range for return on regulated equity (RoRE), and it is unclear how this incentivises the company, or aligns the interests of customers and shareholders. We also have concerns that the plan does not have the right balance of incentives across the company's range of activities, with no caps on outperformance payments and no explanation of customer protection measures if outperformance payments are higher than expected.

Securing long-term resilience

Hafren Dyfrdwy presents unconvincing evidence on its approach to securing long-term resilience, and the plan falls well short in this area. It does not demonstrate a good understanding of current levels of resilience or the process to identify risks and mitigation options. While some elements of resilience are discussed at a high level, it does not demonstrate a commitment to resilience in the round taking into account corporate, financial and operational dimensions. There is no evidence of a systems-based framework to identify risk interdependencies and although the company prioritises risks, it does not detail how these priorities were assigned. The company does not present a resilience maturity assessment and provides limited evidence of

how resilience will be supported by performance commitments. In addition, the way the company presents the results of its financial resilience stress testing means it is not possible to determine the impact of this on key financial ratios. It also provides insufficient evidence that it has a robust approach to risk mitigation and management.

Targeted controls, markets and innovation

The Hafren Dyfrdwy plan demonstrates some aspects of high quality. In particular, it provides the required evidence for RCV allocation and references lessons it has learned from the business retail market opening to competition in England. However, there are concerns with the plan in this test area as it provides insufficient detail on its bid assessment framework, including the information parties will have to provide. Although it presents a detailed approach to assessing the suitability of investments for Direct Procurement for Customers (DPC) it does not provide sufficient evidence as to why further schemes could not be put forward (for example consideration of technical suitability). It also does not demonstrate effective engagement with third party providers on water resources or how it will facilitate a culture of innovation.

Securing cost efficiency

Hafren Dyfrdwy's plan is high quality in this test area. Hafren Dyfrdwy's projected costs for 2020-25 are relatively efficient, with forecast costs in water, wastewater and retail below our benchmark costs. At a company level, its costs are 3% below our view of efficient costs. In water, base costs are around 6% below our view of efficient costs while in wastewater they are around 7% below. All four cost adjustment claims that it submitted were of reasonable or high quality.

Aligning risk and return

Hafren Dyfrdwy's plan falls well short in this area. Its plan includes our 'early view' cost of capital and, in the round, retail margins. However, there are several areas of major concern where the plan falls significantly short. In particular, the company does not demonstrate that the final bill increase for water only customers is supported by acceptability testing. It also does not provide sufficient evidence to support the company's choice of PAYG and RCV run-off rates. We have concerns that its presentation of likely totex outcomes is weighted toward underperformance, on a notional basis, for risk and risk mitigation measures in the RoRE assessment. It also provides insufficient evidence of the steps taken to assess financeability on both the notional and actual structure.

Accounting for past delivery

While the company has good past performance in relation to major incidents, its business plan falls significantly short in all other relevant areas. It provides insufficient evidence to give us confidence in the deliverability of its proposed outcomes due to a lack of historical performance data. Although it demonstrates good actual and forecast performance on costs, it does not acknowledge the large efficiency challenge it has set for 2020-25 and provides insufficient evidence that the plan includes appropriate measures to deliver proposed efficiency improvements. It also provides insufficient evidence that it understands the drivers of its customer complaints handling performance.

Securing confidence and assurance

Hafren Dyfrdwy's plan falls short of high quality in this area. While the company's Board provides the majority of Board assurance statements requested, not enough of these are supported by evidence of the Board's challenge and assurance process. On executive pay the company's plan does not provide adequate evidence that targets will be stretching and rigorously applied. On dividend policy there is also a lack of evidence of the factors that will influence the policy and on future transparency. In addition, the company does not demonstrate that it has a track record of producing high quality data, with minor concerns in six of the areas covered by the company monitoring framework.

2. Next steps and overall timeline

Actions for the company are set out in 'Hafren Dyfrdwy: 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 | Companies submit revisions to business plans (significant scrutiny and slow-track) |
| 18 July 2019 | Draft determinations published (slow-track and significant scrutiny) |
| 30 August 2019 | Close of draft determinations consultation (slow-track and significant scrutiny) |
| 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](#).

- Hafren Dyfrdwy: Test area assessment
- Hafren Dyfrdwy: Test question assessment
- Hafren Dyfrdwy: Actions summary table
 - Hafren Dyfrdwy: Delivering outcomes for customers detailed actions
 - Hafren Dyfrdwy: Accounting for past delivery detailed actions
 - Hafren Dyfrdwy: 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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

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

January 2019

ISBN 978-1-911588-89-4

© Crown copyright 2019

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

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

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

