

January 2019

Trust in water

PR19 initial assessment of plans: Northumbrian 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. 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. 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'. 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 Northumbrian Water's business plan submission under the IAP. It explains our assessment of the company 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 'Northumbrian Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Northumbrian Water 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.

Overall, we categorise Northumbrian Water as slow-track. This categorisation is made after an in the round consideration of our assessment of Northumbrian Water'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.

In our assessment, Northumbrian Water's plan is of high quality in terms of customer engagement, affordability & vulnerability, and aligning risk and return. The company applies a wide range of customer engagement techniques, innovative approaches to encouraging customer participation, and engaging approaches to help customers think about the future. The company proposes sector-leading bill reductions between 2020 and 2025. It also proposes to increase support to customers in vulnerable circumstances, including an ambitious reach for its priority services register and a benefit sharing package, including a mechanism worth up to £0.6 million per year to reduce water poverty and contributions of up to £1.8 million per year to social tariffs and hardship funds. Its plan is based on our early view on the cost of capital and retail margins, and it has provided Board assurance that its plan is financeable and has provided convincing evidence that its choice of pay as you go (PAYG) and regulatory capital value (RCV) run-off rates is appropriate.

However, it falls short of high quality in other areas. Our concerns include:

- **delivering outcomes for customers** – its proposed financial incentives are too low to drive the performance that customers expect and there is insufficient

evidence that customers will be protected if outperformance payments are unduly high;

- **securing cost efficiency** – its company level costs are 15% above our view of efficient costs. In particular, its enhancement costs are higher than our view of efficient and justified costs;
- **securing long-term resilience** – the company’s plan provides a lack of evidence in some areas on long-term resilience, for example lack of evidence of a systems-based approach, and on its approach for identifying and prioritising risks to resilience;
- **targeted controls, markets and innovation** – the company’s plan provides insufficient evidence of engagement with third parties on the development of water resources and bioresources markets and on its process for identifying suitable Direct Procurement for Customers (DPC) projects;
- **accounting for past delivery** – the company’s plan fails to demonstrate how it will improve performance in relation to major incidents and deliver on some of its performance commitments due to their level of stretch; and
- **securing confidence and assurance** – the company does not have appropriate arrangements to share gearing outperformance with customers, despite forecasting gearing close to 70%, and does not clearly explain how its executive pay policy relates to delivery for customers.

Given the scale and scope of these concerns, the plan requires a level of material intervention to protect customer interests. We therefore give the plan slow-track status.

An overview of our assessment in the nine test areas is set out below. Our detailed assessment of the test areas is provided in the ‘Northumbrian Water: Test area assessment’ and ‘Northumbrian Water: 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	C
Aligning risk and return	B
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

The company's plan demonstrates high-quality engagement with customers. It uses a wide range of engagement techniques, including face-to-face interviews, surveys and co-creation events and a three-phase approach to customer engagement. It maintains ongoing engagement with customers, including through its engagement vehicle ("Flo") at community events. It invites customers to attend the senior team conference. It uses a high quality and innovative approach to support customer participation, including running an annual innovation festival and a 'water rangers' scheme.

However, the plan falls short in one area in particular. The company calculates the marginal benefit values for its outcome delivery incentive rates from one source and the company does not provide convincing evidence that this single piece of research is high quality or that it has triangulated with other customer valuation research.

Addressing affordability and vulnerability

The company's plan is of high quality in terms of affordability and vulnerability. It proposes a sector-leading bill reduction and has engaged well with customers on its bill level (although it has not provided detailed information on its acceptability testing). The company proposes to help customers in vulnerable circumstances, including with an ambitious target for increasing the number of customers on its priority services register and a performance commitment for customer satisfaction of those on the register. It proposes to help customers who cannot afford to pay their

bills, including by introducing a performance commitment to reduce the number of households who spend more than 3% of their disposable income on water bills.

The company's plan falls short where it forecasts a bill increase for 2025-30 without providing evidence that it tested the bill profile with customers.

Delivering outcomes for customers

The company's plan demonstrates some aspects of high quality for delivering outcomes. Its performance commitments for 2020-25 and the long term are stretching. For example, it forecasts upper quartile targets for pollution incidents. The company's reporting structures are robust.

However, the company's plan falls short in some areas. It does not sufficiently justify its outcome delivery incentive rates or demonstrate that they are based on robust customer valuations. Northumbrian Water does not provide sufficient evidence that these outcome delivery incentives rates adequately incentivise the company against service under-delivery. It does not propose any protection for customers where outperformance exceeds expectations, or set out its approach to managing bill volatility. It does not demonstrate that its outcome delivery incentives asset health package will address its past performance challenges.

Securing long-term resilience

The plan has considered a wide range of options for operational resilience ranging from traditional infrastructure, catchment options, improving response and recovery, smart wastewater network development, and customer education campaigns. There is evidence of a partnership approach for nature based schemes, and the overall resilience approach for critical water assets is sufficiently justified and convincing.

However, the company's plan falls short in a number of areas. We had concerns about the evidence provided on how it identifies and prioritises risks and the clarity and robustness of its resilience assessment. It provides insufficient evidence on aspirational resilience levels for the 2020-25 period and the long term. The company fails to demonstrate that it has an integrated and systems-based approach to

resilience. The company presents its stress testing results as 'pass'/'fail' outcomes and does not explain the impact on the key financial metrics.

Targeted controls, markets and innovation

The company's plan falls short of high quality in this area.

The company does well on innovation, providing strong evidence of encouraging a climate of challenge and debate, leadership support, setting clear innovation goals and collaborating internally and externally. It also demonstrates an ambitious and innovative approach to managing business gaps and voids, although this contrasts with insufficient evidence of an effective plan for residential gap sites and voids.

The company falls short in a number of areas. It provides insufficient evidence of engagement with third parties on the development of water resources and bioresources markets. While the company bioresource strategy outlines that it is engaging with a third party, it does not demonstrate the potential risks, impacts to services or how customers will share in the benefits from the bioresources market. We also are unconvinced by the technical assessment for rejecting Howden sewage treatment works as a project suitable for DPC. The company also does not provide sufficient evidence of its strategy on bilateral markets.

Securing cost efficiency

The company's plan falls short of high quality in this area. At the company level, Northumbrian Water's costs are around 15% above our view of efficient costs. It is reasonably efficient in terms of base costs (5% above our baseline), but inefficient on enhancement costs (61% above our baseline). Its wastewater costs are less efficient than its water and retail costs. Its wastewater enhancement costs are particularly inefficient where we are challenging both scope and costs. Northumbrian Water also provides no convincing evidence that an interconnection between reservoirs in its Essex and Suffolk region is required.

Aligning risk and return

The company's plan is of high quality in this area. For instance, it is based on our 'early view' cost of capital and retail margins. The plan contains a clear Board statement that the plan is financeable under its actual and notional financial structure. The company also provides convincing evidence to support its choice of PAYG and RCV run-off rates.

Accounting for past delivery

The plan falls short of high quality in this area. In the round we have some concerns with the evidence for deliverability for the 2020-25 plan, in particular for outcomes and major incidents.

There are aspects of high quality. The company forecasts it will underspend against its cost allowance for 2015-20, and it already meets CCWater's 2020 household customer complaints target to resolve 95% of customer complaints at stage one.

However, while the company proposes stretching performance commitments in areas such as leakage and internal sewer flooding, it does not provide sufficient evidence of appropriate measures to deliver improved performance.

The company also had four major incidents in 2015-18. The plan provides insufficient evidence that the company has measures in place to improve performance in relation to major incidents.

Securing confidence and assurance

Overall, the company's plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area. The company's Board provides assurance statements in the majority of the requested areas. However, a number are not supported by sufficient evidence of the Board's challenge and satisfaction process, and a number of statements are not provided in full.

The company proposes a high quality package of benefit sharing, including a mechanism worth up to £0.6 million per year to reduce water poverty and contributions of up to £1.8 million per year to social tariffs and hardship funds. However, the company does not provide enough evidence that it will meet the expectations that we set out in the 'Putting the sector back in balance' position statement. The company forecasts limited headroom to our 70% gearing threshold within the 2020-25 period but does not propose a gearing benefits sharing mechanism. On executive pay, the proposed policy has insufficient evidence of a substantial link to delivery for customers. On dividend policy there is insufficient evidence that there is a strong enough link to delivery of obligations to customers and other stakeholders, and there is no commitment to publish details of the policy annually or signal changes to customers and other stakeholders.

2. Next steps and overall timeline

Actions for the company are set out in 'Northumbrian 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](#).

- Northumbrian Water: Test area assessment
- Northumbrian Water: Test question assessment
- Northumbrian Water: Actions summary table
 - Northumbrian Water: Delivering outcomes for customers detailed actions
 - Northumbrian Water: Accounting for past delivery detailed actions
 - Northumbrian 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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January 2019

ISBN 978-1-911588-88-7

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