

January 2019

Trust in water

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

1. Overview of SES 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 their 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 during the draft and final determination stages.

We categorise SES Water as slow-track. This categorisation was made after an in the round consideration of our assessment of SES 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.

The company performs well on its overall approach to affordability and vulnerability. The company proposes a 5% bill reduction in 2020-2025 which results in bills that are acceptable and affordable to its customers. Although, some aspects of the company's approach to vulnerability fall short of high quality.

The company also performs well on accounting for past delivery with good evidence it can deliver its plan. Its performance in areas such as the deliverability of planned costs and customer complaints is good and it provides sufficient evidence of improvement measures in areas of past delivery where its performance is not as good.

However, we have substantial concerns on cost efficiency where at a company level its costs are 22% above our view of efficient costs, largely driven by higher enhancement costs.

We also have substantial concerns on securing confidence and assurance, where SES Water's Board has only provided a minority of the assurance statements that we require and its proposals on executive pay do not meet our requirements. This

substantially reduces our overall confidence in the assurance in the plan and raises concerns over Board ownership.

SES Water falls short of high quality in other areas. Our concerns include:

- **engaging customers** – the quantity and quality of its customer engagement with insufficient evidence to demonstrate how its customer research has informed the way it set its outcome delivery incentive rates;
- **delivering outcomes for customers** - its overall package of financial incentives, particularly its incentive rates on asset health, are not strong enough to protect customers if the company delivers poor service;
- **risk and return** – there is insufficient evidence to support its proposed company-specific uplift to our ‘early view’ cost of capital or to demonstrate that the plan is financeable and there is insufficient evidence to justify the two proposed uncertainty mechanisms; and
- **long-term resilience** – there is insufficient evidence of a commitment to resilience in the round in areas such as a systems based approach and customer engagement on resilience.

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 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 full in the ‘SES Water: Test area assessment’ and ‘SES Water: Test question assessment’.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	C
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	B
Securing confidence and assurance	D

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 SES Water's business plan falls short of high quality as it provides insufficient evidence in relation to some elements of its customer engagement approach.

The company provides insufficient evidence of its customers' appetite for risk in relation to resilience and long-term measures. It does not clearly demonstrate that it provided its customers with comparative information to help them make an informed choice. It does not provide evidence to demonstrate how the company's customer engagement results have been reflected in its business plan and ongoing operations.

The company provides evidence it has used a range of data sources including 'business as usual' data to complement findings from research done during the development of its business plan.

Addressing affordability and vulnerability

Overall, SES Water's plan provides convincing evidence that its overall approach to affordability and vulnerability is high quality.

It proposes a 5% reduction in real bill decrease between 2020-25 with high customer acceptability and affordability of bills. It also demonstrates that it has engaged with its customers on future priorities and proposes to reduce bills by 6% in the 2025 to

2030 period. It provides evidence of extensive research into the willingness to pay for social tariffs which results in it proposing to double the amount of support it is making available to its customers.

However, certain aspects of the company's approach to vulnerability fall short of high quality as it does not provide sufficient or convincing evidence to support some of the proposals in its plan. For example it proposes ambitious reach for its priority service register but it does not provide evidence on how it will deliver this improvement.

Delivering outcomes for customers

Across the delivering outcomes for customers test area, the evidence SES Water provides to support the performance commitments and outcome delivery incentives it proposes falls short of high quality.

We have concerns with the quality and quantity of its customer engagement on outcomes and its approach to triangulation and willingness to pay research in setting outcome delivery incentive rates. The proposed incentive rates exhibit a number of industry outliers. It is unclear from the evidence it provides how its overall package incentivises the company to deliver better outcomes for its customers. We are concerned that the underperformance payments on asset health are not strong enough to protect customers in the event that the company delivers poor service.

The company's plan proposes a performance level that is upper quartile for supply interruptions for 2020-25.

Securing long-term resilience

SES Water's plan falls short of high quality as the company does not provide sufficient and convincing evidence of securing long-term resilience.

The company provides insufficient evidence of an integrated systems-based approach to resilience. There is little to no evidence of a comprehensive baseline resilience maturity assessment to enable it to understand its level of resilience. The methodology it uses to assess and prioritise risks to resilience is not sufficiently evidenced. It provides limited evidence of the impacts and consequences of the risks identified. It provides unconvincing evidence that it has effectively engaged with its customers on resilience with the customer challenge group (CCG) challenging the company's assurance of service levels for longer-term resilience.

The company models impacts on financial stress scenarios however it does not assess financial resilience against key financial indicators such as interest cover. It

requests a company specific cost of debt adjustment however it does not set out the steps it could take to address its financial resilience without this adjustment.

The company does provide sufficient evidence for some aspects of its financial resilience assessment and risk management. It has clearly set out its proposals to reduce gearing to improve long term resilience (which the company subsequently announced has been achieved).

Targeted controls, markets and innovation

Overall SES Water's plan falls short of high quality across the targeted controls, markets and innovation test area.

The company provides insufficient evidence to demonstrate that market options and third party solutions are appropriately considered for water resources. And it presents insufficient evidence of its understanding of the risks and impacts of opening bilateral markets.

It does not demonstrate learnings from the business retail market.

It provides insufficient evidence to demonstrate its goals and vision for innovation, although it does provide convincing evidence on its approach to encouraging innovation debates and enabling employees to take ownership of innovative ideas.

It provides complete evidence of its RCV allocation approach.

Securing cost efficiency

Overall, SES Water's costs fall significantly short of being efficient in our view. At a company level its costs are 22% above our view of efficient costs. Its residential retail costs are particularly inefficient, being 50% higher than our view of efficient. Its water costs are 19% above our view of efficient costs.

SES water proposes one cost adjustment claim which is of reasonable quality.

Aligning risk and return

SES Water's plan falls short of providing convincing and high quality evidence in the area of aligning risk and return.

The company does not provide sufficient or convincing evidence to support its request for a company specific cost of debt adjustment. It does not clearly evidence

that customers would be compensated for the additional cost of providing an uplift and it does not show convincingly that its customers support funding the uplift.

The company does not provide sufficient assurance that its plan is financeable on the notional or its actual capital structures in its plan.

The company includes two uncertainty mechanisms in its plan however there is insufficient evidence to justify the need.

The company provides convincing and high quality evidence to support its choice of pay as you go (PAYG) and regulatory capital value (RCV) run-off rates.

Accounting for past delivery

SES Water's plan demonstrates high quality across the accounting for past delivery test area.

In the round, we do not have concerns with the evidence for deliverability for the 2020-25 plan. The plan provides sufficient evidence for deliverability in relation to outcomes, costs, major incidents and customer complaints.

The company has delivered or is forecast to deliver 73% of its performance commitments in 2015-20. It provides evidence that it has learnt lessons and put in place measures to improve performance. The company is forecast to underspend against its cost allowance for 2015-20 and the plan contains evidence that it understands the drivers of its cost performance. The company had no major incidents in 2015-18. The company is meeting CCWater's 2020 customer complaint target of resolving 95% of customer complaints at stage one and the number of complaints is declining.

Securing confidence and assurance

Overall, SES Water's plan falls significantly short of providing sufficient evidence to demonstrate confidence and assurance.

The company does provide some evidence of high quality as it is highly geared and accepts our default gearing benefits sharing mechanism and its proposals on dividend policy in general meet our expectations.

However the company's Board provides a minority of the requested assurance statements. This substantially reduces our overall confidence in the assurance of the plan and raises concerns over Board ownership. In addition on executive pay there

is insufficient evidence on how the company's policy demonstrates a substantial link to stretching delivery for customers.

2. Next steps and overall timeline

Actions for the company are set out in 'SES 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](#):

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