

January 2019

Trust in water

PR19 initial assessment of plans: Severn Trent 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 Severn Trent 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 'Severn Trent Water: Actions Summary' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Severn Trent 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.

We are pleased to categorise Severn Trent Water's business plan as fast-track. This categorisation is made after an in the round consideration of our assessment of Severn Trent Water's business plan across the nine test areas, the agreed targeted actions, and the overall 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.

In our assessment of its business plan the company performs well in a number of areas, including:

- **Engaging customers:** It adopts a high quality approach to engaging with its customers, applying a wide range of techniques, focusing on customer participation and co-creation, and trying to better understand the experience of customers who suffered service failures.
- **Affordability and vulnerability:** It proposes to reduce bills by 5%, extend the reach of its social tariff, increase membership of its Priority Services Register to 5% of its customer base, and adopt a high quality approach to using data to identify and help customers in vulnerable situations.
- **Cost efficiency:** At the company level its costs are about 3% above our view of efficient costs. On base costs, the company is below our efficient baselines, and its costs in wastewater and retail are efficient at about 7% and 6% respectively below our baselines.
- **Securing confidence and assurance:** the company proposes a bespoke voluntary benefits sharing mechanism to contribute 1% of profits as a community dividend to support local good causes and to spend £10m on a technical academy. These initiatives could jointly have a value of £4.5m per

year. The company is also proposing contributions to social tariffs and hardship funds which could have a value of £3.5m per year.

We also commend Severn Trent for its 'pathfinding social purpose company' thinking, and for their initiative with the Purposeful Company Taskforce.

While Severn Trent Water performs well in several areas of cost efficiency, we have concerns around its enhancement costs which are about 29% above our baselines.

In the round, we considered that Severn Trent Water's plan should receive fast-track categorisation, though there were targeted actions that it needed to confirm it would undertake to achieve that status. It has accepted those targeted actions and therefore it is categorised as fast-track. The targeted actions include:

- **Cost efficiency:** Adjusting enhancement costs to our efficiency baseline.
- **Outcomes:** Rebalancing the outcome delivery incentive package between its water and wastewater business. This includes reducing the scope for outperformance on sewer flooding, introducing penalties for unplanned water outages, Per Capita Consumption (PCC) of water and the water quality compliance risk index (CRI), and removing outperformance payments on some bespoke performance commitments.

The list of agreed actions are set out in the 'Severn Trent Water: Actions summary table'.

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 'Severn Trent Water: Test area assessment' and 'Severn Trent Water: Test question assessment'. These reflect the business plan that was submitted to us and do not take into account the company's decision to accept our targeted actions.

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	B
Aligning risk and return	C
Accounting for past delivery	B
Securing confidence and assurance	B

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

Severn Trent Water demonstrates a high quality approach to engaging customers. It uses a wide range of effective customer engagement techniques, demonstrating best practice in many cases. It also adopts the four themes set out in our customer engagement best practice 'Tapped In' report to facilitate customer participation in water, and uses a 'design your own plan' budget game to get insights into the experience of customers suffering service failures. However, its outcome delivery incentives do not appear to reflect the results of its customer engagement for a number of performance commitments.

Addressing affordability and vulnerability

Severn Trent Water's approach to affordability and vulnerability is of high quality. It demonstrates comprehensive customer engagement across multiple areas including bills for the 2020-25 period and supporting customers who struggle to pay. On this basis, it proposes to deliver 5% bill reduction while increasing the cross subsidy available for social tariffs (from £3 to £8). It also takes a high-quality approach to vulnerability, proposing a relatively strong increase in Priority Services Register membership to 5% of its customer base by 2024-25, and to use data to identify and help customers in vulnerable situations. However, the company does not demonstrate sufficient customer engagement on future bills.

Delivering outcomes for customers

Severn Trent Water presents some high quality elements in this area though its plan falls short of our expectations overall. It presents an innovative suite of bespoke

performance commitments, proposes high quality outcome delivery incentives for asset health performance commitments, and provides evidence that its proposed outcome delivery incentive package aligns to customer and shareholder interests. The overall size of its package also provides strong protection to customers against failure to deliver on its performance commitments. In addition, the company proposes a robust and innovative approach to reporting against its performance commitments. However, it does not effectively demonstrate that it is proposing appropriate, well-evidenced, and stretching performance commitments across its whole business. The company's outcome delivery incentive package is skewed toward sewer flooding performance commitments in its wastewater business where its performance has historically been better, rather than towards its poorer performing water business. In addition, there are no customer protections in the event that outperformance payments are greater than expected.

Securing long-term resilience

There are a number of high quality elements of the company's approach to resilience including its customer engagement on service delivery risks, its approach to cyber security risk mitigation, and the evidence it provides on long-term financial resilience. It also incorporates a flexible approach to dealing with uncertainty in planning and developing efficient options for resilience, via its 'adaptive pathways' approach.

However, its plan falls short of our expectations for long-term resilience overall. In this respect, it does not present an integrated and systems-based approach to resilience nor a clear resilience maturity assessment. 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.

Targeted controls, markets and innovation

The company's plan falls short of our expectations overall, although there are a number of aspects of the company's approach in this area that we consider to be high quality. In particular, the company demonstrates a capability and culture to support innovation that will deliver environmental and customer results. It also presents evidence on third-party delivery options for water resource demand- / supply-side solutions as well as an innovative water transfer mechanism.

However, the plan does not demonstrate a full consideration of the potential impact of the bilateral market for water resources and presents limited evidence that its draft drainage wastewater management plan (DWMP) fully assesses alternative sustainable or market based approaches. The company does not demonstrate a well-evidenced long-term strategy for delivering bioresources services, providing

insufficient evidence on volume forecasts, costs or revenues. In addition, it presents a summary of its direct procurement for customers (DPC) assessment but does not provide evidence to allow us to determine if it has identified all relevant projects.

Securing cost efficiency

Severn Trent Water's projected costs for 2020-25 are relatively efficient, with total company costs about 3% above our view of efficient costs. On base costs, the company is below our efficient baselines and its costs in wastewater and retail are efficient at about 7% and 6% respectively below our baselines. However, its proposed wholesale water services costs are about 12% above our view of efficient costs. It also proposed 12 cost adjustment claims most of which are not high quality.

Aligning risk and return

There are aspects of the company's plan in this area that we consider high quality. In particular, it is based on our 'early view' cost of capital and retail margins, the pay as you go (PAYG) rates are supported by convincing evidence, and it includes a Board statement confirming the financeability of the plan. However, its plan falls short of high quality overall. It does not sufficiently justify the choice of regulatory capital value (RCV) run-off rates and does not demonstrate sufficient evidence of risk mitigation measures in its return on regulatory equity (RoRE) assessment for the notional company structure, or to support one of its proposed uncertainty measures.

Accounting for past delivery

Severn Trent Water presents a high quality plan in the area of past delivery. It provides evidence of good actual and forecast performance on outcomes and costs, and sufficient evidence for deliverability of the plan across both of these areas. While its performance in dealing with incidents falls short of high quality, largely due to its poor performance in the 2018 freeze thaw incident, it provides sufficient evidence that the plan includes appropriate measures to improve performance in this area. The company demonstrates that it is meeting CCWater's 2020 household customer complaints target, but the plan provides insufficient evidence that it includes appropriate measures to maintain its performance.

Securing confidence and assurance

Severn Trent Water's plan demonstrates high quality in the securing confidence and assurance test area. Its Board provides the majority of the requested assurance statements and there are no material issues with its business plan data. The company also proposes a high quality voluntary sharing mechanism under which it

will contribute 1% of its profits as a community dividend, to be spent on projects that will benefit its customers and communities. In addition, it plans to invest £10 million in a technical academy and to make donations to social tariffs and hardship funds. However the company does not provide enough evidence in its plan that it will meet all of our expectations that we set out in the 'Putting the sector in balance' position statement. For example, on executive pay there is not enough evidence of how stretching targets will be set and on dividend policy the company does not discuss how its policy will take account of its obligations to its pension scheme, which is currently in deficit.

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.

£26 million of this funding will go to Severn Trent Water.

3. Next steps and overall timeline

Actions for the company are set out in 'Severn Trent 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
11 February 2019	Fast-track companies commit to all actions and submit relevant updated data tables by 10am, 11 February 2019
11 April 2019	Draft determinations (fast track plans)
24 May 2019	Close of fast track Draft Determinations consultation
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](#).

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