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Trust in water

PR19 initial assessment of plans: South East Water company categorisation

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

1. Overview of South East 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 categorise South East Water's business plan as slow-track.

This categorisation was made after an in the round consideration of our assessment of South East Water's business plan across the nine test areas and the overall level of intervention required in its plan 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 in a number of areas. For example, its plan includes an innovative and sector-leading approach on vulnerability including four stretching performance commitments. It also proposes a high-quality approach to supporting customers struggling to pay, including a doubling of financial support measures.

The company also performs well across a number of other areas, including:

- **delivering outcomes for customers** - the company is proposing generally stretching performance commitments, an appropriately developed outcome delivery incentive package and well-justified customer protections;
- **targeted controls, markets and innovation** - the company's plan includes strong evidence across all areas of innovation with some evidence of best practice, particularly related to collaboration; and
- **confidence and assurance** - the company's Board provides all of the assurance statements requested to demonstrate that all the elements of its business plan add up to a plan that is high quality and deliverable and that it has challenged management to ensure this is the case. Most of the statements have sufficient supporting evidence.

However it falls significantly short of high quality in the accounting for past delivery area, where the company does not provide enough evidence on the deliverability of an improved performance on outcomes for 2020-25. The plan also falls short on the evidence for deliverability of improved performance in relation to major incidents.

It also falls short of high quality in other areas, including:

- **customer engagement** - the plan lacks ongoing engagement, which demonstrates the lack of a truly embedded and customer-centric approach, and does not demonstrate how the company's segmentation of customers is driving customer outcomes and priorities, shaping delivery of services, or tailoring the approach to engagement;
- **securing cost efficiency** - the company's costs are around 20% above our view of efficient and justified costs, largely driven by higher enhancement costs;
- **aligning risk and return** – there is insufficient evidence around the steps taken to inform the assessment that the plan is financeable or in support of the choice of target credit rating for the actual capital structure; and
- **securing long term resilience –** the company provides insufficient evidence on the approach to risk prioritisation, customer engagement and in demonstrating that its credit rating, one notch above the minimum for investment grade, is consistent with financial 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 'South East Water: Test area assessment' and 'South East 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	B
Securing long-term resilience	C
Targeted controls, markets and innovation	B
Securing cost efficiency	C
Aligning risk and return	C
Accounting for past delivery	D
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

There are a number of aspects of South East Water's plan that are high quality. The company has used a wide range of customer engagement techniques, including both qualitative and quantitative approaches such as focus groups, face to face interviews, online surveys and deliberative events, to engage with a broad range of customers to inform the development of its business plan. The company also has an overall high quality approach to customer participation and engagement with customers on longer term issues. The company considered the needs and requirements of future customers in its business plan and ongoing business operations.

However, the company has not met our overall expectations in this area. This is due to the lack of evidence of ongoing engagement, how the company's segmentation of customers is driving customer outcomes and priorities, shaping delivery of services, or a tailoring the approach to engagement and a lack of robust data, with views based on qualitative studies alone, with no quantitative data to support some findings.

Addressing affordability and vulnerability

The company's approach in this area is high quality. This is demonstrated through the company's innovative approach to addressing vulnerability including four stretching performance commitments – this is sector leading. In relation to customers who are struggling to pay, the company proposes to support these customers by doubling its financial support measures and offering a good spread of schemes.

The plan has limitations in relation to its approach to long term affordability, as it did not engage its customers sufficiently on this subject and there are concerns around its plan to use pay as you go (PAYG) and regulatory capital value (RCV) run rates to adjust its cashflow profile between price review periods. The company is proposing to keep bills flat in real terms over 2020-2025, however the plan does not include credible evidence of how combined bills over this period will impact customers

Delivering outcomes for customers

Across the delivering outcomes for customers test area, the plan proposed by the company is high quality. The plan provides evidence of a balanced package of performance commitments that reflect customer views. The company evidences a high quality approach to its performance commitments at appropriately stretching levels. For example, it proposes achieving upper quartile performance for leakage. The company also proposes a high quality package of standard outcome delivery incentives that are founded on a well-evidenced approach based on customer views, and well-justified customer protections.

There are several areas where the plan falls short of high quality. It has a low ambition for per capita water consumption, does not demonstrate that its proposed performance commitment related to asset health (as measured by the level of mains repairs) is adequately stretching and has not considered appropriate protections to customers within its outcome delivery incentive package.

The company has not applied an appropriate and high quality approach to its focus on service performance and in its risk/reward package. The company also provides insufficient explanation of how its outcome delivery incentive package incentivises it against service under delivery.

Securing long-term resilience

The company's plan falls short of our expectations on resilience. There are some areas of the plan that we consider to be high quality, including its presentation of a good range of mitigation options, its commitment to reduce gearing and an appropriate approach to financial risk mitigation.

However, there are a number of areas where the plan falls short of high quality. We consider the scope of its engagement with customers on resilience to be too limited. The company does not provide sufficient evidence that it has appropriately assessed and prioritised a full range of risks and consequences to its systems and services. There is insufficient evidence of a fully systems-based approach to resilience.

There is insufficient evidence that the company has considered the risks that maintaining a credit rating one notch above the minimum for investment grade, is consistent with maintaining long term financial resilience.

On operational resilience, the company's assessment of mitigation options falls short of high quality. The plan relies more on "resistance" options and traditional engineering solutions, and much less on response and recovery measures.

Targeted controls, markets and innovation

The company demonstrates a high quality approach in this area. The company's plan includes strong evidence across all areas of innovation with some evidence of best practice, particularly related to collaboration. It adequately responds to Ofwat's draft Water Resource Management Plan representations.

The company only demonstrates a commitment to using market led solutions in certain aspects of its plan. On water resources, the plan provides sufficient evidence around third-party engagement and preparation for bilateral markets. However, for water-network plus, there is insufficient evidence that South East Water has given consideration to market solutions.

Securing cost efficiency

We do not consider South East Water's costs to be efficient. At the company level its costs are around 20% above our view of efficient costs, largely driven by higher enhancement costs. Its wholesale water costs are over 23% above our benchmark costs. This is largely due to high projections for costs associated with accommodating new developments.

The company does have relatively efficient costs in the key areas of base costs and retail. Base cost projections are relatively efficient at around 5% above our view of efficient base costs. South East Water's costs for residential retail are efficient at around 4% below our view of efficient retail costs.

South East Water proposes two cost adjustment claims, with one receiving a partial pass while the other fails our quality assessment.

Aligning risk and return

The company's plan does not meet our expectations in this area. While the plan is based on our 'early view' of the cost of capital and retail margins, we have concerns with the level of evidence provided in key areas.

There is insufficient evidence around the steps taken to inform the assessment that the plan is financeable or in support of the choice of target credit rating for the actual capital structure. There is also insufficient evidence in support of its proposed pay as you go (PAYG) and RCV run-off rates, and in particular its proposed adjustment to its PAYG rates. The company also does not demonstrate that its final bill profile reflects customers' preferences.

Accounting for past delivery

The company's business plan falls significantly short of the required quality in this area. We have substantial concerns in relation to the evidence of the deliverability of improved performance on outcomes, given concerns over historical performance, insufficient evidence that it understands the drivers of its performance and a lack of evidence of appropriate measures to deliver the degree of stretch on outcomes in the plan.

We also have some concerns with the evidence of appropriate measures for deliverability of improved performance in relation to major incidents, given its poor performance following the 2018 freeze and thaw where it was required to provide an externally assured action plan.

However, the company has demonstrated aspects of high quality on the evidence for deliverability in some areas. In particular, the company is forecast to underspend its 2015-20 allowance and is already meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at the first stage.

Securing confidence and assurance

Overall the company demonstrates a high quality approach in this area. The company's Board provides the assurance statements requested, most of which are supported by evidence of the Board's challenge and assurance process. The company also provides sufficient evidence that it has a track record of producing high quality data, meeting expectations in five areas and exceeding expectations in two areas covered by the company monitoring framework. However, we identified some concerns with the accuracy and consistency of its business plan tables.

While the company's proposals on its dividend policy are generally high quality, the proposals on executive pay do not meet our expectations. For example there is not enough evidence to demonstrate how meeting customer objectives will be weighted or any reference to stretching targets. We welcome the company's inclusion of our default gearing outperformance benefits sharing mechanism.

2. Next steps and overall timeline

South East Water now has until 1 April 2019 to take the steps we identified as requiring action. There is a full list of actions for the company set out in 'South East 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.

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