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Trust in water

PR19 initial assessment of plans: South Staffs 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’ 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 plan for the period 2020-25. The documents we have published are available on our website.

This document sets our assessment of South Staffs Water’s business plan submission under the IAP. It explains our assessment of the company plan in the round at an aggregate level and sets out a summary of our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the ‘South Staffs 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 Staffs 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 South Staffs Water as slow-track. This categorisation is made after an in the round consideration of our assessment of South Staffs 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, South Staffs Water's plan is of high quality in terms of customer engagement and accounting for past delivery. The company provides high-quality evidence of use of customer segmentation and its approach to customer participation. It demonstrates good performance on costs and customer complaints and provides evidence to support the deliverability of its plan.

We have substantial concerns around the assessment of long-term financial resilience. The company does not demonstrate its commitment to resilience in the round or how it will maintain financial resilience in the long-term, particularly given the concerns on financeability during 2020-25.

We also have concerns in other areas. Our concerns include:

- **securing cost efficiency** - its costs are around 18% above our view of efficient costs;
- **delivering outcomes for customers** - it developed some of its financial incentives using top-down scaling which may not reflect its customers' views;
- **securing confidence and assurance** - it does not have appropriate gearing outperformance sharing arrangements, despite forecast gearing increasing

above 70% in one year under its definition of gearing (and exceeding 70% calculated on the basis of net debt), and insufficient evidence on how its dividends relate to delivery for customers;

- **addressing affordability and vulnerability** – it proposes a long-term bill profile that goes against the wishes of its customers;
- **aligning risk and return** – it provides insufficient evidence to support its choice of regulatory capital value (RCV) run-off rates;
- **targeted controls, markets and innovation** - it has an inadequate bid assessment framework.

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 and our grades for each test area are set out below. Our detailed assessment of the test areas is provided in the 'South Staffs Water: Test area assessment' and 'South Staffs Water: Test question assessment'.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	B
Addressing affordability and vulnerability	C
Delivering outcomes for customers	C
Securing long-term resilience	D
Targeted controls, markets and innovation	C
Securing cost efficiency	C
Aligning risk and return	C
Accounting for past delivery	B
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 range of engagement techniques, including interviews, surveys and role-playing and engages with customers through its online dashboard and its WaterSmart trial, which encourages customers to think about how much water they use. It demonstrates understanding of different customer segments, including hard-to-reach customers. It uses a ‘Community Hub’ and partners with external groups such as Walsall Housing Group and Cambridge City Council. It talks with customers about longer-term issues, including via a ‘Young Innovator Panel’.

However, the plan falls short in some areas. The company used a top-down approach to setting outcome delivery incentive rates and provides no extensive evidence of ongoing engagement with customers prior to May 2017.

Addressing affordability and vulnerability

The company’s plan demonstrates some aspect of high quality in its approach. It proposes to make an 11% cut to real bills in 2020-25 and takes a novel approach to bills, offering to guarantee its customers flat nominal bills. Its customers support this approach.

However, the company falls short of high quality in areas of its approach. While it engaged with customers and tested long-term bill profiles from 2025-2030, the company appears to go against customer wishes in its plans. It proposes relatively weak growth in the number of people on its social tariff compared to other companies, and has not established the level of cross-subsidy to be provided. It also proposes insufficiently ambitious reach for its Priority Services Register and does not seem to distinguish between financial and non-financial vulnerability.

Delivering outcomes for customers

The company demonstrates some aspects of high quality for delivering outcomes. Its performance commitments for 2020-25 are appropriately stretching. In particular, it forecasts stretching levels for reducing leakage.

However, the company falls short in key areas of delivering outcomes. It applies top-down scaling factors to its outcome delivery incentive rates to reach the indicative Return on Regulatory Equity (RORE), resulting in high outcome delivery incentive rates. It provides insufficient justification to use end-of-period outcome delivery incentives and has not tested the potential benefits of in-period outcome delivery incentives with customers.

Securing long-term resilience

The company’s plan demonstrates a holistic resilience assessment through its resilience framework and provides some evidence that it considers a wide range of options to mitigate resilience risks. The company collaborates with farmers as part of their catchment management and wildlife protection schemes.

However, the company's plan falls significantly short in a number of areas in securing long-term resilience. The company does not demonstrate its commitment to resilience in the round and provides no evidence to support the financial resilience scenarios that the company says it has assessed in its plan. The company offers little evidence of an integrated and systems-based approach to resilience and does not demonstrate how it quantifies, assesses or prioritises the resilience risks considered in the plan. It does not demonstrate that the identification and assessment of risks to resilience is embedded in the oversight and decision-making processes.

Targeted controls, markets and innovation

The plan falls short of high quality for this test area, although there are positive elements. The company is ambitious and innovative in its proposals to monitor and incorporate what it has learnt from the business retail market. The company engages with third parties on water resources and considers trades. Its test evidence for its Direct Procurement for Customers threshold is proportionate to the scale of the projects, though it provides insufficient evidence to justify why it excludes schemes on technical grounds

However, the company falls short of high quality in this area. It provides limited information on bilateral markets. It lacks evidence regarding the use of markets for water network-plus. While it emphasises that it puts good practice processes in place, it does not demonstrate an innovative culture. Its bid assessment framework falls short of demonstrating the key principles of transparency, equal treatment and proportionality that we set.

Securing cost efficiency

The company is not efficient compared to our baselines and its costs are around 18% above our view of efficient costs. Its wholesale water costs are around 21% above our efficient view of costs. Its supply-demand balance unit costs are more marginally efficient than the industry benchmark and the company proposes one cost adjustment claim, which receives a partial pass.

Aligning risk and return

The company demonstrates some aspects of high quality in this test area. The plan is based on our 'early view' cost of capital and retail margins and provides convincing evidence for the company's choice of pay as you go (PAYG) rates.

However, the company falls short of high quality. It fails to demonstrate that its choice of target credit rating on the notional structure is appropriate in the context of its investment programme and funding needs. It fails to demonstrate the consistency of its plan with the proposed target credit rating on its actual structure, given the deteriorating financial ratios over 2020-25. It provides insufficient evidence to support its choice of regulatory capital value (RCV) run-off rates. It does not adequately explain how it reconciles customer support for flat bills during the period 2020-30, with its proposal for flat bills in cash terms during 2020-25 and inflationary costs carried over into 2025-30. It does not justify its risk and risk mitigation measures in the assessment of return on regulatory equity (RoRE) for the notional company and the assumptions of exposure to revenue risk.

Accounting for past delivery

Overall, the company's plan demonstrates high quality in accounting for past delivery. We do not have concerns with the evidence for deliverability for the 2020-25 plan in any of the areas assessed, covering outcomes, costs, major incidents and customer complaints. The company has delivered, or is forecast to deliver, 71% of its performance commitments in 2015-20. There is sufficient evidence that the plan includes measures to meet future performance commitments. The company is forecast to spend in line with its cost allowance for 2015-20. The company had no major incidents in 2015-18. The company is already meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at stage one and has a low and falling number of household customer complaints.

Securing confidence and assurance

Overall, South Staffs Water's plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area. However, the company's Board provides statements of assurance in the vast majority of requested areas. Most of these statements are supported by sufficient evidence of the Board's challenge and assurance process.

The company's proposals on executive pay generally meet our expectations and it proposes donations to social tariffs and hardship funds, which are high quality in the context of its size as a company. However, the company forecasts gearing of about 70% at the end of the 2020-25 period and proposes a gearing benefits sharing mechanism that offers fewer benefits to customers than our default mechanism.

There is insufficient evidence that the company's dividend policy meets our requirements, in particular, on how dividends will be linked to delivery for customers and how future changes will be communicated to customers and other stakeholders.

2. Next steps and overall timeline

Actions for the company are set out in the 'South Staffs 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 Staffs Water: Test area assessment
- South Staffs Water: Test question assessment
- South Staffs Water: Actions summary table
    - South Staffs Water: Delivering outcomes for customers detailed actions
    - South Staffs Water: Accounting for past delivery detailed actions
    - South Staffs 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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