

January 2019

Trust in water

PR19 initial assessment of plans: South West 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'. 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 West 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 West 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 West Water categorisation

1.1 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 South West Water's business plan as fast-track. This categorisation is made after an in the round consideration of our assessment of South West Water's business plan across the nine test areas, the agreed targeted actions 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.

South West Water's plan was assessed as high quality across a range of test areas. Its plan includes ambitious, innovative and sector-leading proposals. For example, it leads the sector with its outcome performance commitment and incentives package, where it is pushing itself to go further including in areas particularly important to customers such as reducing pollution incidents and incidents of sewer flooding inside customer premises. On customer bill affordability and support for customers in vulnerable circumstances, it proposes a real bill reduction of 14% between 2020 and 2025 (and forecasts the largest bill decrease in the sector between 2025 and 2030). It is the only company committing to regularly checking the accuracy of its priority services register. It proposes an ambitious voluntary benefits sharing mechanism with its customers, WaterShare+, which includes outperformance on the cost of debt, and will enable customers to receive shares in the company.

Other areas it performs well on include:

- **securing cost efficiency** - where its costs are within 5% of our view of efficient costs;

- **securing long-term resilience** - where it identifies risks that cover a wide range of options and provides good evidence of stakeholder collaboration to develop solutions;
- **engaging customers** - conducting high-quality customer engagement and using a range of customer engagement techniques, such as interactive online videos; and
- **aligning risk and return** - its plan is based on our early view on the cost of capital and retail margins, and has provided Board assurance that its plan is financeable and sufficient evidence to support choice of pay as you go (PAYG) and regulatory capital value (RCV) run-off rates.

But the company plan fell significantly short on its performance for past delivery, particularly against its targets for major pollution incidents. South West Water has the worst performance in pollution incidents (category one and two) per 10,000km of sewer in the sector for 2015-18. The plan provides insufficient evidence that the company has learnt lessons from this experience and that the plan includes appropriate measures to address this performance.

In the round, we considered that South West 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. These actions include committing to address concerns about past delivery by improving its Environment Agency Environmental Performance Assessment (EPA) Rating with a penalty only performance commitment to achieve a four star rating by 2024-25.

The list of agreed actions are set out in the 'South West 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 'South West Water: Test area assessment' and 'South West 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 to achieve fast-track status.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	B
Addressing affordability and vulnerability	B
Delivering outcomes for customers	B

Securing long-term resilience	B
Targeted controls, markets and innovation	C
Securing cost efficiency	B
Aligning risk and return	B
Accounting for past delivery	D
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 demonstrates a high-quality approach to engaging customers. It uses a wide range of customer engagement techniques. It has adopted innovative customer behaviour change schemes involving customers earning points for saving water and an initiative where customers can choose how to share in company financial rewards. It creatively engaged with customers about risk and their expectations about service

Addressing affordability and vulnerability

The company demonstrates a high quality approach. It proposes a relatively large bill reduction of 14% during 2020-25 and receives high customer support for its approach on overall affordability. It also forecasts a bill reduction of 12.5% during 2025-30. It proposes to help customers in vulnerable situations, including a sector-leading commitment to add customers to its priority services register and checking the data. It proposes to help customers who struggle to pay by proposing a large increase to its affordability schemes.

Delivering outcomes for customers

The company demonstrates a high-quality approach. It has a balanced package of performance commitments that, overall, reflects customer views and in some cases, it proposes appropriately stretching performance levels, forecasting upper quartile performance on internal sewer flooding and pollution incidents.

Its standard outcome delivery incentives are high quality, balanced and ambitious, although it provides insufficient detail on what level of protection it will give to customers in case its outperformance payments are much higher than expected.

Securing long-term resilience

The company demonstrates a high-quality approach. It considers a wide range of options to mitigate resilience risk, including its initiatives on Upstream Thinking and Downstream Thinking. It engages with a wide range of stakeholders and customers. It targets financial ratios consistent with an investment grade credit rating and proposes to maintain its gearing at around 63%.

However, it does not sufficiently demonstrate an integrated and systems-based approach to resilience.

Targeted controls, markets and innovation

The company has an innovative approach to securing resilient and sustainable water resources, creating an internal water resources market. There is strong evidence of partnerships and catchment strategies, especially to deliver sustainable wastewater solutions. It collaborates with third parties such as Exeter University on innovation and natural capital approaches. Its approach to identifying and assessing projects that could be suitable for Direct Procurement for Customers (DPC) is of high quality, identifying two potential projects. Both projects were rejected as the case for a DPC approach was marginal, though the justification was not convincing. Its bid assessment framework is consistent with best practice.

However, the company did not demonstrate how its corporate values of innovation translate into organisational and functional innovation goals.

Securing cost efficiency

Overall, we consider the company's 2020-25 cost projections to be efficient. At the company level, its costs are slightly above our view of efficient costs. Its costs on water activities are in line with our view of efficient costs. However, its wastewater costs are 5% above our view of efficient costs and its retail costs 14% above our view of efficient costs.

Aligning risk and return

The company is high quality in several areas. Its business plan is based on our Final Methodology 'early view' cost of capital and retail margins. It provides a clear board statement that plan is financeable under its actual and notional financial structures with appropriate evidence to support this. It demonstrates convincing evidence to support its choice of PAYG and RCV run-off rates.

Accounting for past delivery

Overall, the plan falls well short of the required quality in accounting for past delivery and does not demonstrate that it has put in place sufficient measures to ensure that the 2020-25 plan is deliverable.

While the company has performed well on costs it falls short in particular on major pollution incidents. The company has the worst performance on the most serious pollution incidents in the sector and the company provides insufficient evidence that the plan includes appropriate measures to address this performance. It also provides insufficient evidence that there are appropriate measures in place to deliver its stretching performance commitments for 2020-25 and reduce its total number of complaints (although it is already meeting the CCWater 2020 target of resolving household customer complaints).

The company provides sufficient and convincing evidence to support the PR14 reconciliations both in terms of the rationale provided and the accuracy of the calculated adjustments.

Securing confidence and assurance

Overall, South West Water's plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area. The company does demonstrate high quality in some areas. For example, the company's Board provides assurance statements in the majority of the requested areas and most are supported by sufficient evidence of the Board's challenge and satisfaction process.

The company proposes an ambitious voluntary benefits sharing mechanism, which includes outperformance sharing on the cost of embedded debt, a share ownership scheme for customers from the cost of new debt, and donations to social tariffs and hardship funds. However, the company does not fully demonstrate that it will meet all of our expectations in Ofwat's putting the sector in balance document.

2. Next steps and overall timeline

Actions for the company are set out in 'South West 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 for fast-track plans
24 May 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 West Water: Test area assessment
- South West Water: Test question assessment
- South West Water: Actions summary table
 - South West Water: Delivering outcomes for customers detailed actions
 - South West Water: Accounting for past delivery detailed actions
 - South West 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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