

January 2019

Trust in water

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

1. Overview of Thames 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 welcome Thames Water's acknowledgement that "the reality that things haven't gone as well as planned in recent years" and says that it is making substantial changes. It states that "Thames is a very different company to 18 months ago". We support the proposed transformation of the way Thames Water delivers for customers.

We have placed Thames Water in the Significant Scrutiny category. This categorisation is made after an in the round consideration of our assessment of Thames 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.

While Thames Water's plan falls significantly short of high quality in a number of areas, which we detail below, there are some high quality elements. For example, it has used a range of techniques to engage with customers and the company proposes ambitious growth for its social tariff, to assist customers who need help with bills. There is also convincing supporting evidence for the company's pay as you go (PAYG) and regulatory capital value (RCV) run-off rates and the plan is based on our 'early view' cost of capital and retail margins.

Thames Water's plan falls significantly short of our view of cost efficiency. Its costs are 25% above our view of efficient and justified costs. Its water, wastewater and retail costs are all higher than our view on efficient costs.

The company's plan falls significantly short on long-term resilience – particularly its operational resilience – and leaves customers at higher risk of poor service, including loss of water supply. We are not convinced by its understanding of its asset health, particularly as its asset health performance commitments do not propose enough improvement. We are also not convinced it has considered all relevant factors associated with maintaining long-term financial resilience in the context of its high-level of gearing.

Thames Water's plan on accounting for past delivery also falls significantly short, particularly in demonstrating that it can deliver the outcomes for customers it proposes. For example, there is insufficient evidence that the plan includes appropriate measures to ensure that it can meet its leakage reduction targets, given its past performance and the level of improvements in the plan. There is also a lack of evidence that its plan includes appropriate measures to deliver lower costs, improve performance in relation to major incidents (including following the 2018 freeze thaw) and reduce the number of customer complaints, given its poor past performance in these areas.

Thames Water falls short in other areas of the plan, including:

- **engaging customers** - the business plan does not reflect customers' views in all areas;
- **addressing affordability and vulnerability** – there is low support from customers for affordability and acceptability of bills;
- **delivering outcomes** - performance commitments proposed are not stretching in some key areas including leakage, per capita consumption and supply interruptions, and do not reflect customer preferences. The company's proposals for financial incentives are likely to be too low to improve performance;
- **confidence and assurance** - it does not accept our gearing benefit sharing proposal, despite forecasting gearing will be above 70%;
- **aligning risk and return** - lack of evidence on the financeability of the company

Given the extent to which the plan falls significantly short of high quality and the material interventions required to protect customers, we have placed Thames Water in the significant scrutiny category. We commit to working closely with the company over the coming months to enable it to address the issues, to improve the overall quality of its plan and therefore the service it intends to provide to customers.

An overview of our assessment of 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

‘Thames Water: Test area assessment’ and ‘Thames Water: Test question assessment’.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	C
Addressing affordability and vulnerability	C
Delivering outcomes for customers	C
Securing long-term resilience	D
Targeted controls, markets and innovation	C
Securing cost efficiency	D
Aligning risk and return	C
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

There are some areas where the company has provided sufficient evidence of a high quality approach. For example, a variety of customer engagement techniques were used.

However, there are areas where the plan falls short of a high quality approach, for example:

- There is little detail on the results from the segmented customer research and how the results are reflected in the plan.
- The company has not reflected the themes from the ‘Tapped In’ report on customer participation.
- Although an innovative customer engagement tool was used, it was not clear how the results of that engagement informed the business plan.
- Some proposed performance commitments were not stretching enough and some outcome delivery incentives were not sufficiently aligned with value to the customer.

Addressing affordability and vulnerability

The plan demonstrates a high quality approach on certain aspects of affordability. For example, in helping customers who cannot afford their bills, the company proposes an ambitious growth rate for its social tariff. However, the plan does fall short in the following areas overall:

- There are low levels of customer support on affordability testing with an unconvincing approach to customer engagement.
- Plans for long-term affordability provide insufficient and unconvincing evidence of customer engagement. The company forecasts the highest long-term bill increase in the sector for the 2025-30 period. It received the support of only 60% of its customers, which is below the 63% threshold it set for itself.
- It projects a relatively low reach in its Priority Services Register (PSR) membership, given the company has identified a greater population are eligible, and its engagement with customers in vulnerable circumstances was poor.

Delivering outcomes for customers

There are some aspects of high quality, for example, the company's approach to reporting structures. However, we do have concerns:

- Insufficient stretch of proposed commitment levels for important measures such as leakage, per capita consumption of water, water supply interruptions and insufficient evidence about the level of mains repairs. For leakage, Thames Water's plan commits to a 15% reduction, but given the company's current poor performance we think the company should be pushed to go further. The company also needs to develop a well evidenced plan for how it will deliver these reductions.
- Some outcome delivery incentive rates for material performance commitments, including leakage and internal sewer flooding, are considered too low to provide adequate performance incentives.
- The overall package of performance incentives is not sufficiently balanced across the range of the company's activities. For example, the largest financial incentives do not always reflect customers' highest priorities.
- There is no proposed approach from the company about how customers will be protected if outperformance payments are much higher than expected.

Securing long-term resilience

Overall, the plan falls significantly short in this test area. In particular, we are concerned about the lack of evidence for securing long term operational resilience. The plan lacks sufficient and convincing evidence of the following:

- An integrated and systems-based approach to resilience.
- Robust corporate systems for monitoring and managing resilience risks.
- Evidence that the external resilience maturity assessment underpins the company's planned actions and mitigations.
- That the company has a good understanding of the condition of its assets.
- That the company has considered all financial risks that come from its highly geared structure.

Targeted controls, markets and innovation

Although there are some strong elements of the plan, there was a lack of convincing evidence across water resources and bio-resources. For example, on water resources, despite a good level of engagement with third parties and proactively exploring water export options, the strategy for bilateral markets is unconvincing. Issues raised by Ofwat on the draft Water Resources Management Plan have not been fully resolved. The plan does not sufficiently consider the opportunity to use bioresource market solutions to address its capacity needs.

For innovation the plan fell short of high quality with insufficient evidence of its overall capability to innovate and especially in terms of having the right environment and space.

Securing cost efficiency

The plan falls significantly short of the required quality. Its costs at a company level are around 25% above our view of efficient costs. Water, wastewater and retail costs are all higher than our view on efficient costs too.

Many of the company's cost adjustment claims were not supported by appropriate evidence, with two out of eight claims being assessed as good quality.

Aligning risk and return

There are high quality elements to the plan. For example, there is convincing supporting evidence for the company's pay as you go (PAYG) and regulatory capital value (RCV) run-off rates. In addition, the plan is based on our 'early view' cost of capital and retail margins.

The Board has provided a statement that the company is financeable and able to fund its operations. However, there is one important area where the plan falls short as the company has not provided sufficient assurance that its funding from

operations (FFO) / net debt financial ratio is consistent with the target credit rating on its actual structure.

Accounting for past delivery

The plan falls significantly short of providing evidence of appropriate measures to ensure the deliverability of the company's 2020-25 plan, in particular in relation to outcomes, costs, major incidents and complaint handling. The main issues are:

- The company provides insufficient evidence that it has appropriate measures in place to deliver its leakage targets over 2020-25, given its failure to meet leakage targets so far over 2015-18.
- The company is forecast to spend more than its allowed costs in 2015-20. The company does not provide enough evidence that it has learnt lessons or that its plan includes appropriate measures to address this.
- The company had seven major incidents over 2015-18 and was required to produce an externally assured action plan following its performance in the 2018 freeze and thaw review. The company provides sufficient evidence that it understands the drivers of its performance relating to major incidents, but there is insufficient evidence that the plan includes appropriate measures to address performance.
- The company is meeting CCWater's 2020 target for resolving customer complaints. Although complaint numbers are falling, they are high, and the company does not provide enough evidence that it understands the drivers of its performance relating to complaints.

Securing confidence and assurance

Overall, Thames Water's business plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area. The company does not provide enough evidence that it will meet the expectations set out in the 'putting the sector back in balance' document. The company forecasts it will be highly geared over the period 2020-25, but it does not include an appropriate gearing outperformance sharing mechanism. There is not enough detail that the company's dividend and executive pay policies will meet the expectations that we set out in the 'putting the sector in balance' position statement.

Additionally, the company provides a majority of the requested Board assurance statements, but some of these are not supported by evidence of Board challenge and some of the requested statements are not provided in full.

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.

£151 million of this funding will go to Thames Water.

3. Next steps and overall timeline

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

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