

January 2019

Trust in water

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

1. Overview of Wessex Water's 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 Wessex Water as slow-track. This categorisation is made after an in the round consideration of our assessment of Wessex 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.

The company performs well in the following test areas:

- **engaging customers** - it uses a wide range of engagement techniques including ongoing engagement and customer participation in service delivery;
- **affordability and vulnerability** - it demonstrates an ambitious and innovative approach to help customers that cannot afford to pay their bills and a high quality approach to help customers in vulnerable circumstances;
- **targeted controls, markets and innovation** - it is ambitious and innovative in its use of market based solutions, with some evidence of delivering further change through innovation; and
- **accounting for past delivery** - it provides sufficient and convincing evidence overall on the deliverability of the 2020-25 plan, given past performance.

Although the company performs well in these areas generally, it does not mean that the areas are without issue. For example, it does not demonstrate engagement with its customers on a large potential bill increase that would take effect beyond 2025.

It falls significantly short of high quality with respect to the balance of risk and return in its business plan as the company does not convincingly justify its proposed

increase to our early view of the cost of capital. It also has not demonstrated that it is targeting appropriate credit ratings and it is not possible to reconcile the financial metrics used to support the Board's assessment of notional financeability with the ratios in its financial model.

The business plan also falls short in a number of other areas, including the following:

- **cost efficiency** - its costs, in particular its enhancement costs, are higher than our view of efficient and justified costs;
- **delivering outcomes** - its outcomes package could lead to significant outperformance payments. This is of note with respect to the drinking water Event Risk Index performance measure, which is not sufficiently stretching but has the potential for Wessex Water to receive significant outperformance payments. There is also a lack of evidence to support the use of outperformance payments for a number of performance commitments;
- **securing long-term resilience** - it does not demonstrate a systems-based approach to resilience. It also provides insufficient evidence around long-term and financial resilience because its business plan is based on a cost of capital that is higher than our early view; and
- **securing confidence and assurance**: it provides a lack of detail around how its proposals on executive pay and dividend policy meet our requirements.

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 'Wessex Water: Test area assessment' and 'Wessex Water: Test question assessment'.

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	B
Securing cost efficiency	C
Aligning risk and return	D
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

An overview of our assessment across the nine test areas are set out below.

Engaging customers

The company demonstrates a high quality approach to engaging its customers. It uses a wide range of effective customer engagement techniques and innovative ongoing engagement approaches. It also maintains a two-way dialogue with customers and uses comparative data to provide customers with context around relative industry performance. In addition, the company adopts the four themes of customer participation set out in Ofwat's 'Tapped In' best practice report. Although it provides evidence of high quality triangulation, the company does not demonstrate customer support for its largest value performance commitment (the drinking water events risk indicator (ERI)). It also sets outcome delivery incentive rates that are not based on an assessment of the service levels that customers value. In addition, we found limited evidence of Wessex Water carrying out customer research regarding long-term bill profiles.

Addressing affordability and vulnerability

Wessex Water's approach in this area is high quality. In addition to a proposed 3.5% bill reduction in 2020-25, it demonstrates an ambitious and innovative approach to help customers that cannot afford to pay their bills and a high quality approach to help customers in vulnerable circumstances. However, the evidence it provides on how acceptable its customers find its bill, and how it has tested whether customers consider its bills to be affordable, is unclear. The company does not demonstrate sufficient customer engagement regarding its forecast bill increase of 7.2% for 2025-30.

Delivering outcomes for customers

Wessex Water's business plan falls short of our expectations in this area. It proposes stretching targets for some performance commitments, for example reducing external sewer flooding. However, its proposed target for its drinking water quality performance commitment (ERI) is not sufficiently stretching, but creates the potential for Wessex Water to receive significant outperformance payments. There is also insufficient evidence to support Wessex Water using outperformance payments for other performance commitments. Wessex Water also demonstrates some evidence of selecting bespoke performance commitments in areas where it has historically performed well, instead of addressing areas of poor performance.

Securing long-term resilience

The company's plan falls short of our expectations on resilience. We consider some areas of the plan to be high quality including its Entrade platform (which creates online reverse auctions to deliver environmental improvements), its approach to customer engagement on resilience risks and options, and its comprehensive flood risk assessment. However, it does not demonstrate an established systems-based approach to resilience in the round and although it presents a baseline maturity assessment, this only covers the period to 2022. The plan lacks evidence in a number of areas including the assessment of risks to resilience, the methodology to prioritise resilience risks, and its approach to selecting mitigating options. It also presents insufficient evidence that it has considered the impacts of all risks in its assessment of financial resilience and its business plan is underpinned by a higher cost of capital than our early view.

Targeted controls, markets and innovation

The company demonstrates a high quality approach in this area. It is ambitious and innovative in its use of market-based solutions, shows good evidence of third party engagement on water resources, and references trialling an Open Systems Coordinator approach to bring direct procurement into the centre of its procurement strategy. However, it does not demonstrate that it has fully considered the impact of the opening of the bilateral market for third party provision of water resources in England or the use of markets to treat sludge. While it demonstrates some evidence of innovation, the link between strategic challenges, innovation activity, and its focussed management of innovation culture is unclear. The commentary in its plan on direct procurement is high quality but it does not explain how it would evaluate schemes that are close to the direct procurement threshold. While its bid-assessment framework is aligned to best practice, it is not sufficiently detailed.

Securing cost efficiency

We have concerns around the company's cost efficiency particularly around enhancement costs. At the company level, projected costs are around 14% above our view of efficient costs. Although its base costs for wastewater are efficient, these are offset by relatively inefficient wastewater enhancement costs as well as inefficient water base and enhancement costs.

Aligning risk and return

We have significant concerns regarding the company's approach to aligning risk and return. It provides limited and unconvincing evidence to support its proposed uplift to

our early view of the cost of capital and that its customers support the uplift or will benefit from it. There is insufficient evidence that the financial metrics used to support the Board's assessment of notional financeability are valid as it is not possible to reconcile these ratios with the submitted PR19 Financial Model. There is also insufficient detail regarding how Wessex Water is targeting its credit rating. In addition, it does not fully consider risks to the return on regulatory equity (RoRE) or associated risk mitigation measures. However, the plan does meet our expectations in relation to the choice of pay as you go (PAYG) and regulatory capital value (RCV) run-off rates.

Accounting for past delivery

Our assessment suggests that overall the company has a high quality approach in this area. It has delivered, or is forecast to deliver, 86% of its 2015-20 performance commitments, while underspending against its cost allowances. It already meets CCWater's 2020 household customer complaints target and demonstrates its senior leadership ownership of this process. Although it dealt with one major pollution incident between 2015 and 2018, it provides sufficient evidence that the plan includes appropriate measures to improve performance in relation to major incidents.

Securing confidence and assurance

Overall, the company's plan falls short of demonstrating high quality in the securing confidence and assurance test area. While the Board provides assurance statements in the majority of the areas that we requested, not enough of these statements provide sufficient evidence of the Board's challenge on the quality and deliverability of the plan. The company proposes a voluntary sharing mechanism on outcome delivery incentive payments that is high quality, considering the company's size. However the company does not provide enough evidence that it will meet our expectations on putting the sector in balance. On executive pay the policy covers all the required areas but has insufficient detail. On dividend policy there is a lack of detail on how commitments to customers will be taken into account.

2. Next steps and overall timeline

Actions for the company are set out in 'Wessex 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](#).

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

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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