# Thames Water: Test area assessment

| All company test area grades | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Engaging customers | Addressing affordability and vulnerability | Delivering outcomes for customers | Securing long-term resilience | Targeted controls markets and innovation | Securing cost efficiency | Aligning risk and return | Accounting for past delivery | Securing confidence and assurance |
| C | C | C | D | C | D | C | D | C |

| Thames Water - test area results | | | | |
|---|---|---|---|---|
| **Test area** | **Overall test area grade** | **Overall test area summary assessment and rationale** | **TQ#** | **Test question grade** |
| Engaging customers | C | Overall the business plan falls short of high quality with insufficient evidence in the areas set out below.<br><br>Thames Water provides sufficient evidence of a high quality approach in the following areas:<br>• Application of a broad range of customer engagement techniques in order to collect a robust and proportionate evidence base.<br>• The company's willingness to pay surveys follow best practice guidance and are subject to academic peer review.<br>• Innovative use of gamification techniques via an interactive customer engagement tool and the trialling of subjective well-being analysis.<br>• Use of comparative information to provide context to customers.<br><br>However, the business plan falls short of high quality with insufficient evidence, in the following areas:<br>• While the business plan provides sufficient evidence of the company engaging with a broad range of customer segments, including a wide range of vulnerable customers, little detail is found on the results of this engagement and the extent to which results are reflected in the business plan.<br>• The company is adopting the Futures and Action themes of customer participation, with little evidence found of incorporating the Communities and Experience themes (as referred to in the Tapped In report).<br>• The company provides sufficient evidence that it has effectively engaged with current and customers on longer term issues and taken into account the needs of future customers, including some innovative approaches, such as in the use of a customer engagement tool that effectively uses gamification to understand customer service level priorities when faced 'with real life trade-offs' and its futurology workshops. However, it provides insufficient evidence of how this engagement informed the business plan.<br>• The company proposes a Performance Commitment (PC) target for supply interruptions that was not considered stretching when tested with customers and an out/underperformance outcome delivery incentive (ODI) for the low-pressure PC when the results of its engagement indicated it should be have underperformance payment only. | EC1 | C |
| Addressing affordability and vulnerability | C | Overall the plan falls short of high quality with insufficient evidence of its approach to affordability and vulnerability, but it demonstrates a high quality approach in relation to:<br>• helping customers who cannot afford their bills. It proposes an ambitious growth rate for its social tariff in AMP7 and proposes a PC to support this.<br><br>The business plan falls short of high quality with insufficient evidence in the following areas:<br>• It achieved low scores in its acceptability and affordability testing for AMP7. | AV1 | C |
| | | | AV2 | D |
| | | | AV3 | B |

| Thames Water - test area results | | | | |
|---|---|---|---|---|
| **Test area** | **Overall test area grade** | **Overall test area summary assessment and rationale** | **TQ#** | **Test question grade** |
| | | • Plans on long-term affordability were insufficient and unconvincing. Bills are forecast to rise by 8.9% in AMP8, the highest increase in the sector. The company received 60% of support for this plan, lower than the 63% threshold it set as an indication of success.<br>• Insufficient evidence was provided on vulnerability, including an insufficient projected reach for its Priority Services Register (PSR), and poor engagement with customers on this issue. | AV4 | C |
| Delivering outcomes for customers | C | Overall, across the delivering outcomes for customers test area the evidence Thames Water provides to support its proposed PCs and ODIs in its plan falls short of high quality and the evidence is insufficient or unconvincing in some areas.<br><br>The plan provides evidence of a high quality approach in some specific areas, particularly its approach for performance reporting structures and adopting in-period ODIs by default.<br><br>However, the plan provides insufficient evidence that the company has appropriate, well-evidenced and stretching PCs. Additionally, the evidence supporting its package of ODIs is insufficient and provides unconvincing evidence that it has a sufficient focus on appropriate service delivery within its overall risk/return package.<br><br>Key areas where the business plan falls short of high quality are:<br>• Insufficient stretch for leakage, per capita consumption, supply interruptions and the deterioration in asset health measured by the level of mains repairs is not sufficiently evidenced.<br>• Insufficient evidence that the ODI rates for PCs including leakage and internal sewer flooding provide adequate performance incentives and Insufficient evidence has been provided with regards to the scaling factors used.<br>• The overall package is not considered balanced, for example the largest financial incentives do not always reflect customers' highest priorities; and<br>• It has not set out how it will protect customers if outperformance payments are higher than expected. | OC1<br><br>OC2<br><br>OC3 | C<br><br>C<br><br>C |
| Securing long-term resilience | D | Overall, the plan falls significantly short of high quality and the company does not provide convincing evidence of securing long term resilience in certain areas. In particular, we have significant concerns over the company's evidence presented in relation to securing long term operational resilience.<br>The company's resilience assessment provides some evidence of support from customer engagement and undertaking a comprehensive resilience maturity profile. The company's plan assesses a range of mitigation options for the resilience risks identified, although only at a high level, including environmental options and has evidence of support from customers.<br><br>However, we consider that the company plan does not provide sufficient and convincing evidence of a commitment to resilience in the round in the following areas:<br>• The company's resilience assessment falls short of high quality and provides little evidence of an integrated and systems-based approach to resilience.<br>• The company does not provide convincing evidence that it has robust corporate systems for monitoring and managing resilience risks, necessary to secure long-term resilience. | LR1 | C |

| Thames Water - test area results | | | | |
|---|---|---|---|---|
| **Test area** | **Overall test area grade** | **Overall test area summary assessment and rationale** | **TQ#** | **Test question grade** |
| | | • There is limited evidence that the external resilience maturity assessment underpins the company's planned actions and mitigations to improve resilience to convince us that the company is taking appropriate steps.<br>• The company's plan sets out that a significant percentage of its customers are exposed to severe water restrictions for the price control period, although exposure is expected to reduce in the long term.<br>• The company provides little evidence to convince us that it has a good understanding of the condition of its assets, despite historically poor operational resilience. The plan also lacks convincing evidence on how the company will improve its asset health.<br>• Although the company shows the results of financial stress scenario test on its key financial ratios, it has primarily considered risks in relation to its debt covenant commitments. It provides insufficient evidence of considering possible impacts on its current credit ratings (one of which is on negative outlook) in the context of requirements to refinance subordinated debt, which is a feature of its highly geared structure.<br>Although the company sets out a planned reduction in its gearing level, it will still be relatively high at around 76%. In addition, the company does not provide sufficient evidence that it has considered the risks presented by an associated increase in debt for other group companies above the ring fence. Thames Water has not considered possible impacts of the mechanism for sharing financing outperformance for companies with actual gearing levels of 70% and above.<br>• The plan provides insufficient evidence that the natural environment is integrated in its resilience framework. | LR2 | D |
| Targeted controls, markets and Innovation | C | Overall, Thames Water's plan falls short of high quality across the Targeted Controls, Markets and Innovation test area and evidence is insufficient and/or unconvincing in some areas.<br>Thames Water's Bid Assessment Framework meets all best practice recommendations. The approach proposed for gaps and voids, including the use of financial incentives, is ambitious and innovative. Similarly there is strong evidence of the use of markets including partnerships and catchment strategies across network plus water.<br><br>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. The evidence of the approach to collaboration is high quality, but not ambitious or innovative. On water resources, however, 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 (WRMP) have not been fully resolved. Despite a clear bioresources strategy and good level of engagement with third parties, the plan does not sufficiently consider the opportunity to use bioresource market solutions to address its capacity needs during AMP7 and in the future as an alternative to the significant investment to increase treatment capacity. In addition, the company does not provide sufficient evidence to assure Ofwat that its sludge volume forecasts are robust, particularly where the narrative does not align with the data. The company provides evidence that it has considered DPC as part of its investment programme. While the evaluation process is of high quality, the plan provides insufficient evidence on individual schemes to justify the conclusions. | CMI1<br>CMI2<br>CMI3<br>CMI4<br>CMI5<br>CMI6<br>CMI7 | C<br>C<br>C<br>C<br>C<br>B<br>C |
| Securing cost efficiency | D | Overall, Thames Water's plan falls significantly short of the required quality in this area. We do not consider the company's projections for 2020-2025 to be efficient when compared against our baselines. At the company level its costs are around 25% above our view of efficient costs. In addition, many of the company's cost adjustment claims fail to provide detailed supporting evidence.<br><br>The company's costs in water and retail are above our view of efficient costs by around 36% and 31% respectively, while in wastewater its costs are around 13% above our view of efficient costs. Costs are not efficient in either base or enhancement programmes.<br><br>The company proposes eight cost adjustment claims, two are of good quality and we score as a marginal pass, three claims we give a partial pass for the quality of the claim, and the remaining three are of poor quality and fail. This gave Thames a score of D for its cost adjustment claims as many of the claims fail to provide detailed supporting evidence. | CE1<br>CE2<br>CE3<br>CE4 | D<br>C<br>D<br>D |

| Thames Water - test area results | | | | |
|---|---|---|---|---|
| **Test area** | **Overall test area grade** | **Overall test area summary assessment and rationale** | **TQ#** | **Test question grade** |
| Aligning risk and return | C | Despite some aspects of Thames Water's plan which are high quality, shortcomings in other aspects mean that it overall falls short of providing convincing and high quality evidence to support its approach in the area of aligning risk and return.<br><br>The following areas of the plan are high quality:<br>• It is based on our Final Methodology 'early view' cost of capital and retail margins.<br>• There is convincing evidence to support the company's choice of PAYG and RCV run-off rates.<br>• There is convincing evidence to support the board's statement that the company is financeable on the notional structure based on adjusting the assumptions for dividend policy and/or the level of index-linked debt.<br><br>The plan falls short of high quality in the following main area, which is sufficiently material to affect the overall score for the aligning risk and return test question:<br>• Further assurance is required that its FFO/net debt financial ratio is consistent with the target credit rating on its actual structure.<br><br>While there is high quality and convincing evidence in the company's assessment of risk for the notional company in its RoRE analysis in the round, we have concerns that the company's presentation of likely totex outcomes is weighted towards underperformance on a notional basis. | RR1<br>RR2<br>RR3<br>RR4 | B<br>B<br>C<br>B |
| Accounting for past delivery | D | Overall, Thames Water's business plan falls significantly short of the required quality in accounting for past delivery.<br><br>In the round we have substantial concerns with the evidence for deliverability for the 2020-25 plan, in particular in relation to outcomes, and some concerns in relation to costs, major incidents and customer complaints handling.<br><br>The plan falls short of high quality for deliverability in the following areas.<br>• The company has delivered or is forecast to deliver 76% of PCs with financial ODIs in 2015-20. However, we have substantial concerns as the company provides insufficient evidence that it can deliver its proposed leakage targets in 2020-25, given its failure to deliver leakage commitments in 2015-20. We also have some concerns with a number of other common and bespoke PCs. We therefore have substantial concerns with the evidence for deliverability for outcomes.<br>• The company is forecast to overspend against its cost allowance in 2015-20. There is insufficient evidence that the company has learnt lessons and that the plan includes appropriate measures to address this performance. We therefore have some concerns with the evidence for deliverability of the planned costs.<br>• The company has poor performance on major incidents, as it had seven major incidents in 2015-18 and was required to produce an externally assured action plan following the 2018 freeze and thaw review. The company provides sufficient evidence that it understands the drivers of its performance and learnt lessons from it, but it provides insufficient evidece that the plan includes appropriate measures to address performance, and so we have some concerns with the evidence for deliverability on major incidents.<br>• The company is meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at stage one but it has a high, although falling, number of customer complaints. The company provides some evidence on measures, but its assessment of the drivers of its performance is insufficient, and so we have some concerns with the evidence for deliverability on customer complaints handling.<br><br>There is sufficient and convincing evidence for five out of eight PR14 reconciliation areas and insufficient evidence for ODIs, residential retail and service incentive mechanism. There is unconvincing evidence that a change to the Counters Creek PC is in customers interests. There is a marginal difference (1.8% of 2019-20 revenue) between expected and proposed reconciliations. In the round, the evidence for the PR14 reconciliations is not sufficient to raise the accounting for past delivery test area score. | PD1<br>PD2 | B<br>D |
| Securing confidence and assurance | C | Overall, Thames Water's business plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area.<br><br>The company's business plan provides some evidence of high quality: | CA1 | C |

<table>
<tr><th colspan="5">Thames Water - test area results</th></tr>
<tr><th>Test area</th><th>Overall test area grade</th><th>Overall test area summary assessment and rationale</th><th>TQ#</th><th>Test question grade</th></tr>
<tr><td rowspan="5"></td><td rowspan="5"></td><td rowspan="5">The company’s Board provides a compliant statement of assurance with sufficient supporting evidence to demonstrate that the business plan will deliver – and that the Board will monitor delivery of – its outcomes.<br><br>The company’s business plan provides sufficient and convincing evidence that overall, its business plan tables and the assurance and commentary provided are consistent, accurate and assured.<br><br>The plan falls short of high quality in the following areas:<br><br>The Board provides assurance statements in the majority of requested areas to demonstrate that all the elements of its business plan add up to a plan that is high quality and deliverable. However, an insufficient number are supported by evidence of the Board’s challenge and assurance process and a number are not compliant. This reduces our overall confidence in the assurance of the plan and the Board’s ownership.<br><br>In our assessment of the company in the 2018 Company Monitoring Framework (not including the elements related to the PR19 business plans) while the company exceeds expectations in 2 areas and meets expectations in 6 areas, it has minor concerns in 2 areas.<br><br>The plan falls significantly short of high quality in the following areas:<br><br>On providing evidence of a fair balance between customers and investors:<br>• On gearing benefits sharing, the company is highly geared but does not commit to introducing a gearing benefit sharing mechanism.<br>• On dividend policy, there is insufficient evidence of the company’s intention to meet the expectations set out in the ‘Putting the sector in balance’ position statement. There is insufficient evidence that the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends.<br>• On executive pay, the company demonstrates insufficient evidence of its intention to meet the expectations set out in the ‘Putting the sector in balance’ position statement. There is insufficient evidence of how the targets will be stretching and aligned with delivery to customers. Also, there is no reference to the policy for 2020-25 and how it will be rigorously applied and monitored or evidence as to how changes will be signalled to customers.<br>• The company’s Board does not provide a compliant assurance statement that the company’s business plan will enable customers’ trust and confidence through high levels of transparency and engagement on corporate and financial structures and how this relates to its long term resilience.<br>• The company is proposing a bespoke outperformance sharing mechanism on the cost of debt which we assess is likely to have zero value and donations to social tariffs and hardship funds which we assess could have a value of £0.5m per year. The scale of the proposals for voluntary sharing are very modest in the context of the company’s size. However, voluntary sharing mechanisms are not a requirement of the PR19 methodology, so the proposed sharing does not impact our assessment in this test area.<br>• However the company has proposed a base dividend yield less than 5%.<br>• Additionally, there is sufficient evidence of transparency on the company’s corporate and financial structures and how these relate to its financial resilience.<br><br>The company’s Board provides a non-compliant statement of assurance to demonstrate that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term.</td><td>CA2</td><td>D</td></tr>
<tr><td>CA3</td><td>D</td></tr>
<tr><td>CA4</td><td>B</td></tr>
<tr><td>CA5</td><td>C</td></tr>
<tr><td>CA6</td><td>B</td></tr>
</table>