

PR19 initial assessment of business plans
Overview, past delivery and confidence and assurance

7 February 2019

- 09:30 Overview
- 10:00 Past delivery
- 10:45 Confidence and assurance

Overview

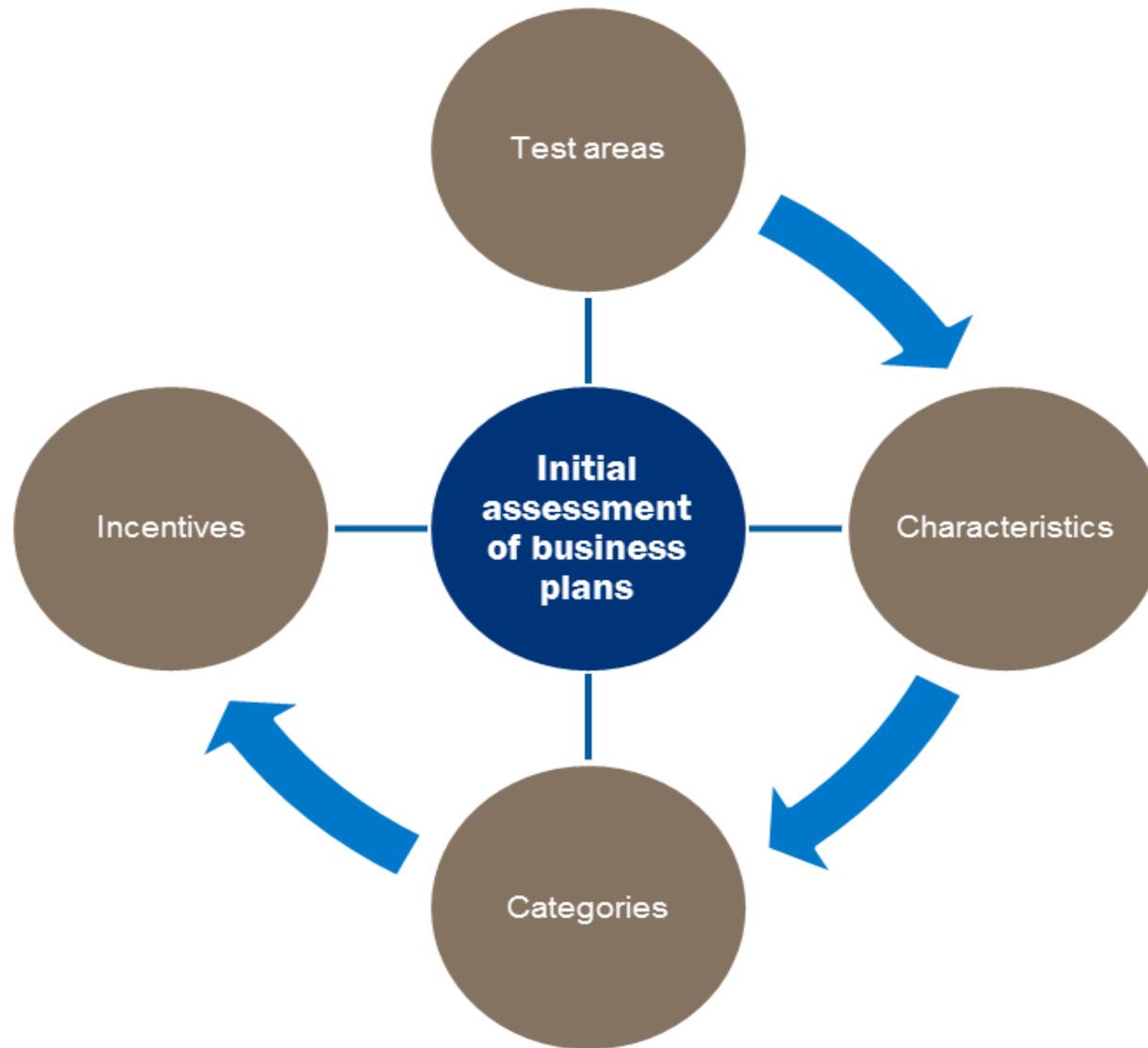
We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet needs of future customers and protect and improve the natural environment.

The initial assessment of business plans tests company plans against our requirements and expectations.

We welcome the huge efforts made by companies in developing their business plans and helping to move the sector forwards.

Where companies have not met our high expectations, we have set out a series of actions to allow us to set draft determinations of companies price, service and incentive packages.

The purpose of the webinars is to provide you with an overview of how we have approached the assessment, provide a guide to the documentation and to answer cross company questions. Company specific questions should be made through the queries process.



Initial assessment test areas

Engaging customers	Enhanced customer engagement; customer participation; engaging customers on long-term issues including resilience
Addressing affordability and vulnerability	Addressing affordability and vulnerability: affordability for all, now and in the long term, including those struggling to pay and services that are easy to access.
Delivering outcomes for customers	Performance commitments, outcome delivery incentives, appropriateness of overall package
Securing long-term resilience	Resilience 'in the round'; risk identification and risk mitigation
Targeted controls, markets and innovation	Innovation Use of markets Direct procurement for customers
Securing cost efficiency	Assessment of base and enhancement expenditure Cost adjustment claims
Aligning risk and return	Cost of capital, retail margins, risk assessment and mitigation, Use of PAYG/RCV run off levers Financeability
Accounting for past delivery	2015-2020 reconciliation; confidence in business plans
Securing confidence and assurance	Board assurance, Putting the sector in balance, data quality

In PR19 methodology we stated that we expected business plans to meet three overarching characteristics: high quality, ambition and innovation.

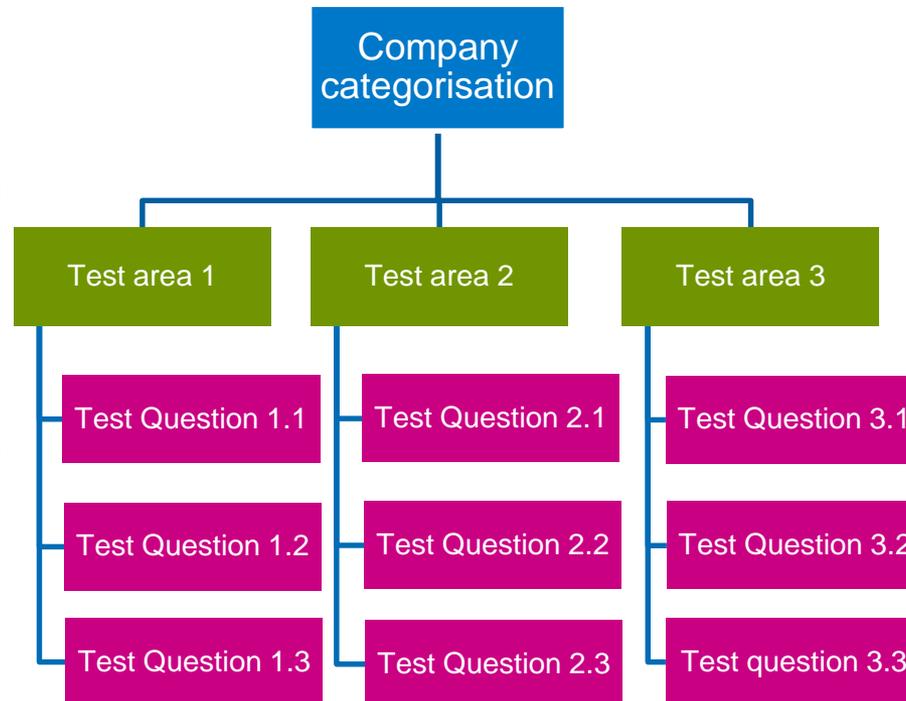
Grade	
A	High-quality, ambitious and innovative plan with evidence that overall is sufficient and convincing
B	High-quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing
C	Concerns with the plan: Plan falls short of high quality 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

A grades cannot be achieved in all test questions and are not applicable to the 'aligning risk and return' and 'taking account of past delivery' test areas

Test areas are based on an 'in the round' assessment of the test question assessment, placing greater emphasis on individual test questions where appropriate.

Test area grades were used to make the final company categorisations. There are **9** test areas.

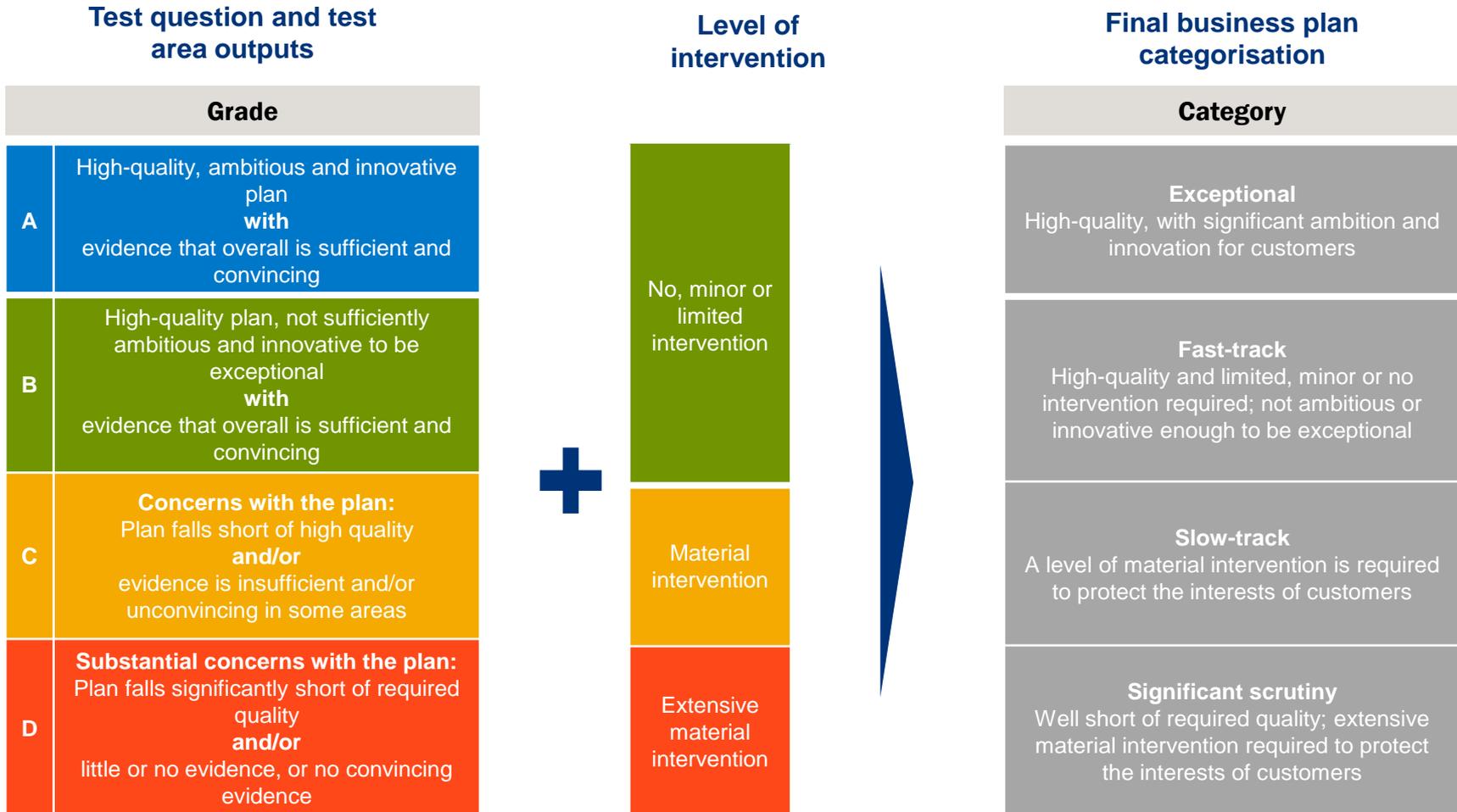
Test question grades were used to award test area grades. There are **33** test questions.



Approach to the categorisation of business plans

Business plan categorisation is based on an in the round assessment of test area grades and the overall level of intervention required in the plan.

We set a high bar for fast track status.



Actions are required to protect customers and the environment.

Actions include providing more evidence or clarification to substantiate part(s) of the business plan or reworking and/or resubmitting part(s) of the business plan because it falls short of the required quality.

There are three types of actions.

- 1. Agreed actions** that fast track companies committed to implement to ensure that their plans meet the threshold for fast track status.
- 2. Required actions** for companies which in general are required so that we can make draft determinations (or final determinations for some aspects of past delivery).
- 3. Advised actions** for companies to do by a specific date but that are not required for our draft determinations.

Actions are set out in the action summary table and detailed actions documents.

PR19 initial assessment of plans: Overview of company categorisation setting out a high-level summary of the results of our initial assessment of companies' business plans

PR19 initial assessment of plans: Summary of test area assessment setting out our overall approach to the initial assessment of business plans and our key findings by test area, together with supporting documents.

Technical appendix 1: Delivering outcomes for customers

Technical appendix 2: Securing cost efficiency

Supplementary technical appendix: Econometric approach

Supplementary technical appendix: Europe Economics Frontier shift and real price effects

Supplementary technical appendix: KPMG totex and outcomes report

Technical appendix 3: Aligning risk and return

Technical appendix 4: Company specific adjustments to the cost of capital

Bid assessment framework information note

For each water company: **PR19 initial assessment of plans: Company categorisation** setting out for our reasons for the category given to that company's business plan together with supporting documents (as required).

Test area assessment

Test question assessment

Actions summary table

Delivering outcomes for customers detailed actions

Accounting for past delivery detailed actions

Securing confidence and assurance detailed actions

Direct procurement for customers detailed actions

Template action tracker

Common performance commitment outline for the Priority Service Register

PR19 initial assessment of plans: Glossary

PR19 price setting models map

PR19 initial assessment of business plans: Past performance models

PR19 initial assessment of business plans: Cost assessment models

Next steps

We will operate a queries process to assist development of revised business plans through pr19engagement@ofwat.gsi.gov.uk

	Next steps	Date
Fast-track companies	Companies must submit information, including: <ul style="list-style-type: none">• completed business plan tables; and• an actions tracker.	11 February 2019
	Draft determinations	11 April 2019
	Respond to draft determinations	24 May 2019
Slow-track and significant scrutiny companies	Companies must submit information, including: <ul style="list-style-type: none">• a revised business plan;• completed business plan tables;• a completed Ofwat financial model; and• an actions tracker.	1 April 2019
	Draft determinations	18 July 2019
	Respond to draft determinations	30 August 2019
All companies	Final determinations	11 December 2019

Past delivery

First, past delivery – and how the companies assess, learn from and respond to that experience – is an important indicator of whether they will be able to deliver against their plans for 2020-25.

Secondly, we assess whether the water companies report their actual performance accurately so that the ‘reconciliations’ for the previous price review determinations are correct. This ensures that customers only pay for the service that they have and will receive.

How well has the company given evidence for its proposed reconciliations for the 2015-20 period, and has it proposed adjustments by following the PR14 reconciliation rulebook methodology?

We considered reconciliations for the following areas:

- **totex;**
- **outcomes;**
- **wholesale revenue forecasting incentive model;**
- **household retail;**
- **water trading;**
- **land sales;**
- **service incentive mechanism;** and
- **2010-15 reconciliation** (blind year).

We examined historic and forecast performance.

We examined accuracy, consistency with the PR14 reconciliation rulebook methodology and supporting evidence.

Companies that perform well on this test provided sufficient and convincing evidence to support their actual data for 2015-18 and forecasts for their anticipated performance in 2018-19 and 2019-20. They also undertake the reconciliations consistently with the methodology in the reconciliation rulebook.

Companies generally performed well on this assessment, with a step up in performance compared to PR14, with generally accurate and evidenced reconciliations with only small differences to expected values.

Biggest concern was evidence for forecasts where evidence from some companies was lacking.

We have set out actions for the PR14 reconciliation in the past delivery detailed actions documents. For most mechanisms we are asking for additional evidence on forecasts for 1 April. This will allow us to consult on any proposed adjustments. For all mechanisms we are asking companies to update their reconciliations on 15 July to take account of the 2018-19 data.

We have also published our past delivery models. The past delivery models use companies' data submission to us in July 2018 – except where the companies' narratives for their September 2018 submissions describe changes to the proposed adjustments. In these cases the models use the September 2018 data submission. The models do not reflect other minor updates to data from the September 2018 submissions, although we have corrected for obvious differences between the submitted models and tables.

Question 2 (deliverability assessment): How well has the company performed, and is forecast to perform, over the 2015-20 period and, taking into account this overall performance, how well has it put measures in place to ensure that it maintains confidence that it can successfully deliver its PR19 business plan?

We consider past performance across four key areas:

- **outcomes**;
- **costs** (total expenditure);
- **major incidents** (including environmental and water quality incidents, the response to the 2018 freeze and thaw and where statutory and license obligations have not been met); and
- **customer complaints** handling.

In each of these four areas, we assess past and forecast performance for the 2015-20 period, whether the company identifies drivers of performance and lessons learnt, and the measures it has put in place to improve its performance.

For outcomes and cost performance, we take account of the level of stretch in the 2020-25 business plan when assessing whether the proposed improvement measures are sufficient.

Companies that perform well on this test either:

- perform strongly in the current period and their plans include appropriate measures to ensure that they continue to do so; or
- perform less well, but provide convincing evidence that they have learnt lessons and their plans include appropriate measures to ensure performance will improve in the future and they will be able to deliver their business plan.

We place the greatest weight on outcomes and cost performance because these will have the greatest impact on customer service and bills going forward.

For areas where we have identified concerns, we have asked companies to:

- provide additional evidence on the drivers of past performance, lessons learnt and measures that they intend to put in place; and
- develop an action plan to help to ensure that this is a continuous process.

Where companies have fallen well short in a particular area then these actions are required, otherwise they are advised. For slow track and significant scrutiny companies these actions need to be completed by 1 April 2019 for required actions and 24 May 2019 for advised. Where actions are required we will provide feedback to companies.

The overall grade for this test area is based on a combination of the grades from the two past delivery test questions. We place the greatest weight on the deliverability assessment (question 2) because this is likely to have the greatest impact on customers.

We have substantial concerns either because

- there are significant past performance issues and we have substantial concerns about the evidence that the plan includes appropriate measures to address them; or
- while past performance is acceptable, the plan provides insufficient evidence that the planned level of stretch for 2020-25 can be delivered.

Further details are set out in the test area summary document, test area and test question assessments and past delivery detailed actions.

Confidence and assurance

It is vital that customers and stakeholders, including Ofwat, have confidence in water companies' business plans.

The securing confidence and assurance test considers six questions which cover three different elements:

- **Board assurance (questions one, two, three & four)**

Through the provision of Board assurance statements we expect company Boards to own and be accountable for their plans, the delivery of resilience and the delivery and monitoring of outcomes.

- **Evidence of a fair balance between customers and investors (question three)**

We expect companies to meet the expectations of our 'Putting the sector in balance' position statement on gearing benefits sharing; executive pay; and dividend policy. Companies may also propose to voluntarily share benefits with customers— although this is not mandated.

- **High quality, consistent and assured data (questions four and five)**

We expect high quality and consistent data and for companies to demonstrate a good track record of this.

Question 1 To what extent has the company's full Board provided comprehensive assurance to demonstrate that all the elements add up to a business plan that is high quality and deliverable, and that it has challenged management to ensure this is the case?

Question 2 To what extent has the company's full Board been able to demonstrate that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term?

Question 3 To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence, through appropriate measures to provide a fair balance between customers and investors (which include outperformance sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement on issues that matter to customers (which extends to their ability to understand corporate and financial structures and how they relate to its long-term resilience)?

Question 4 To what extent has the company's full Board provided comprehensive assurance to demonstrate that the business plan will deliver – and that the Board will monitor delivery of – its outcomes (which should meet relevant statutory and licence obligations and take account of the UK and Welsh Governments' strategic policy statements)?

Question 5 To what extent does the company have a good track record of producing high-quality data, taking into account the company's data submission, assurance process and statement of high quality, and our 2018 assessment of the company under the company monitoring framework?

Question 6 How consistent, accurate and assured are the company's PR19 business plan tables, including the allocation of costs between business units, information on corporation tax, and the assurance and commentary provided

We assess for **high quality** across all six test questions and therefore can award **B grades** across all test questions.

We assess for **ambition** in voluntarily sharing benefits with customers within test question three and therefore can award an **A grade** for this test question

We assessed for the provision of **Board assurance statements** within:

- **Question one**

Board assurance requirement: 16 statements that demonstrate that business plans are high quality and deliverable ([PR19 Final Methodology](#) p. 227-8).

Evidence requirement: The Board's satisfaction process for all statements and the Board's challenge process for statements on business planning.

- **Question two**

Board assurance requirement: statement that the Board's governance and assurance processes will deliver operational, financial and corporate resilience.

Evidence requirement: the Board's satisfaction process.

- **Question three**

Board assurance requirement: statement that the company has or will engage with customers on its corporate and financial structures.

Evidence requirement: the Board's satisfaction process.

- **Question four**

Board assurance requirement: statement that the plan will deliver and that the Board will monitor delivery of its outcomes.

Evidence requirement: description of how the Board will monitor outcome delivery.

High quality Board assurance statements are compliant and are supported by sufficient evidence of the Board's satisfaction and, where required, challenge process.

Statement compliance

Compliant statements are provided by the Board and provide assurance on all material components of the statements requested in the final methodology.

Final methodology Board assurance requirements	Board's actual statement of assurance	Statement compliance	Why is the Board's assurance statement partially or non-compliant and what action does the company need to take?
CA9.11) Assurance that the expenditure forecast included in the company's business plan are robust and efficient	We have collectively satisfied ourselves that the assurance undertaken demonstrates that our business plan: • Is built on expenditure forecasts which have been produced using a robust and efficient process	Partially-compliant	<p>Reason The Board provides assurance that the process used for developing expenditure forecasts is robust and efficient, but not that the expenditure forecasts are robust and efficient.</p> <p>Action No action</p>

Sufficient evidence of Board satisfaction

Evidence that the Board or its members have considered evidence on the topic of each statement constitutes sufficient evidence of Board satisfaction, examples include:

- Board meeting items
- List of papers reviewed by the Board
- Board explains how or why it is satisfied

Sufficient evidence of Board challenge

Evidence that the Board or its members have interacted with company employees on the topic of each statement constitutes evidence of Board challenge, examples include:

- Details of specific challenges made
- Records of deep dives conducted between Board members and company employees

Actions on Board assurance statements

Companies with plans classified as slow track or significant scrutiny have actions to provide the forward looking Board assurance statements that we assess as partially- or non-compliant.

Each company has a detailed actions document for this test area. In this document we advise which statements are forward looking, whether the company's Board is required to provide a revised statement and the reasons for partially- and non-compliant statements.

Securing confidence and assurance test area 9

Identifying where companies are required to restate Board assurance statements

CA9.1 To what extent has the company's full Board provided comprehensive assurance to demonstrate that all the elements add up to a business plan that is high quality and deliverable, and that it has challenged management to ensure this is the case?

Final methodology Board assurance requirements	Board's actual statement of assurance	BP Reference	Statement compliance	Company action required?	Why is the Board's assurance statement partially or non-compliant and what action does the company need to take?	Action reference	Forward or backward looking?
CA9.1a) All the elements add up to a business plan that is high quality and deliverable;	"The Board assures: • that the submission is a high-quality and deliverable plan"	Page 1 of the BAS	Compliant	No			Backward looking
CA9.1b) The overall strategy for data assurance and governance processes delivers high-quality data.	"data submissions and, in particular, the allocation of costs and assessment of taxation, are accurate, reliable and complete."	Page 1 of the BAS	Compliant	No			Backward looking
CA9.1c) The business plan will enable the company to meet its statutory and licence obligations, now and in the future and take account of the UK and Welsh Government's strategic policy statements;	"that it is consistent with, and will allow the company to deliver against, its statutory obligations now and up to 2025"	Page 1 of the BAS	Partially-compliant	Yes	<p>Reasons The Board's assurance statement does not make reference to its licence obligations or UK strategic policy statement.</p> <p>Actions Provide a restated and compliant Board assurance statement.</p>		Forward looking

Within question three we seek evidence that companies' policies on dividends, performance related executive pay and gearing benefits sharing for 2020-25 meet the expectations of our 'Putting the sector in balance' position statement.

Dividend policy

We sought evidence of:

- Clear description and detail of the policy for 2020-25
- A stated base dividend yield for 2020-25
- A statement that the proposed yield is based on the company's actual structure (or our calculations demonstrate this)
- Inclusion of the key components and how they are taken into account when determining dividends
- Commitment to transparent publication of the policy, including signalling of changes and the reasoning for them

Performance related executive pay

We sought evidence of:

- Clear description and detail of the policy for 2020-25
- Inclusion of the key components and their link to short- and long-term stretching delivery for customers
- How the policy has or will be developed and implemented
- How the policy will be monitored and rigorously applied
- Commitment to transparent publication of the policy, including signalling of changes and the reasoning for them

Actions

Some companies provided sufficient evidence that their proposals meet our key expectations.

A number of companies do not provide sufficient evidence that performance related executive pay targets are stretching or how policies will be applied and monitored. Companies may have been developing their proposals in this area since business plan submission and so we have set actions for all companies to provide further updates and demonstrate that they will deliver the best outcomes for customers.

Gearing benefits sharing

Within question three we seek evidence that companies with high gearing will share the benefits of that high gearing with customers. We test company proposals against the default mechanism set out in our '[putting the sector in balance](#)' position statement. We are most concerned where companies are highly geared and have not adopted a suitable mechanism.

Actions

Most companies include our default mechanism in their plan. However there are some companies that have not, including some that are highly geared. We have set actions for these companies to include our default mechanism.

Voluntary benefits sharing

We did not mandate that companies propose voluntary shareholder funded returns of benefits with customers, however companies that do could demonstrate ambition on test question three and improve their score for the test area overall. We seek evidence that:

- Potential returns are sufficiently large in the context of the company's size.
- Proposed sharing is shareholder funded.

We consider contributions to new and existing schemes, eg social tariffs.

Within question five we seek evidence of the company's track record of producing high quality data. We consider:

- **Performance in the 2018 company monitoring framework (excluding components related to business plans):**

We assess the extent to which companies meet or exceed expectations in our assessments of the company monitoring framework (excluding business plan elements) in-line with the policy framework set out within our June 2018 [final position statement](#).

- **Evidence that performance and financial data within business plans are consistent with data reported elsewhere, or inconsistencies are sufficiently explained**

We conduct an in the round assessment placing greatest weight on the consistency of companies' data in the priority areas of cost assessment, outcomes, financial modelling and risk and return.

- **Evidence within the business plan of plans and processes for producing and assuring high quality data**

- **Evidence of lessons learnt from companies' 2017 company monitoring framework categorisations**

We assess whether companies adequately explain the interventions they have implemented to address areas of weakness identified in our 2017 assessments.

Actions

We have set some companies actions to complete on the data component of our assessment of test question five which are found in the company specific detailed actions documents.

Within question six we seek evidence that companies' business plan data tables are accurate, consistent and assured.

Scope of assessment

Our assessment considers up to ten policy areas and places greatest weight on the policy areas of cost assessment, outcomes, financial modelling and risk and return. Our assessment considers whether:

- Tables are accurate and complete
- Validation checks are satisfied
- Consistency with: companies' submitted financial models; line definitions and guidance; cost allocation guidelines in RAG 4.07 and; tax information
- The extent to which we needed to raise queries on material issues and the quality of companies' responses to our queries

Actions

We have set some companies actions to complete which are found in each company's detailed actions document.

Actions are either required or advisory. Advisory actions are indicative of issues identified within our assessment that we recommend companies consider and address. Not all policy areas have provided actions to companies and the absence of actions does not indicate that we identified no material issues in our assessment.

We have released a new business plan table template and a new financial model. The tables, when populated, should reflect all responses to queries since September, as well as reflecting the actions from the IAP assessment.

There are six questions within the test area.

Questions one, three and five directly address the purpose of the test area. These questions have the greatest weight in determining the test area grade.

For the test area overall:

A grade: the business plan is high quality in all of the test questions and proposes an ambitious voluntary sharing mechanism.

B grade: the business plan is high-quality in at least two of the most influential test questions – questions one, three and five – or are high quality in one of these high priority test questions and provide high-quality plans in the majority of the remaining questions.

C grade: the business plan falls short of high quality in at least two of the high priority questions.

D grade: the business plan falls short of high quality in multiple high priority questions and significantly short of high quality in test question one.

How we conducted our initial assessment in this test area, sector performance and examples of good practice and where improvement is required:

- [PR19 initial assessment of plans: Summary of test area assessment](#) – chapter 12

Reasoning for the test area grade:

- [Company specific test area assessment documents](#) – test area 9

Reasoning for the test question grades:

- [Company specific test question assessment documents](#)

Required and advisory actions:

- [Company specific actions](#)

Detailed required and advisory actions on Board assurance and data:

- [Company specific detailed actions](#)

Questions