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Trust in water

PR19 draft determinations

Significant scrutiny companies – Application of lower cost sharing rates and outcome delivery incentive cap

Ofwat

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1. Introduction

In our initial assessment of plans we categorised four companies' business plans as significant scrutiny – Thames Water, Southern Water, Affinity Water and Hafren Dyfrdwy. Our assessment considered plans against three overarching characteristics of high quality, ambition and innovation. Significant scrutiny plans fell well short of the required quality and needed extensive material intervention to protect their customers' interests. Our assessment accounted for the number of areas of concern and the extent of the concerns.

In our PR19 methodology we said significant scrutiny companies would receive reduced cost sharing rates. We said that this would mean that significant scrutiny companies would keep only 25% of their cost outperformance and bear 75% of cost underperformance. We also said we would consider capping, including down to zero, the outcome delivery incentive outperformance payments on bespoke performance commitments for significant scrutiny companies.

However, as part of our initial assessment of plans we explained that we would take a modified approach. Rather than committing to reduce cost sharing rates and implement outcome delivery incentive caps for significant scrutiny companies, we said in 'PR19 initial assessment of plans: Overview of company categorisation' that 'we will consider whether this is still appropriate…if companies effectively address the issues identified in our initial assessment of their plans'. We also explained that 'we would relax this approach if we have clear evidence that the companies engage positively to address our concerns with their plan over the remainder of the price review process'.

This means that we will make our final decision on whether to implement the PR19 methodology approach to reduce cost sharing rates and implement outcome delivery incentive caps in our final determination on 11 December 2019. This document provides further information on our current view and our expectations on the four significant scrutiny companies for the remainder of the price review process through to final determinations. This is based on the engagement of, and material submitted by, each of the four companies since the initial assessment of plans. This is principally, but not only, the revised business plans that each company submitted by 1 April 2019.

2. Where companies had to improve

On 31 January 2019, we published a suite of documents for each company that explained in detail our assessment of business plans across nine test areas, summarised in Table 1 below. We recognised that while each significant scrutiny company faced different challenges, and each is going through a period of change, in each case there were areas where the plans fell significantly short of high quality.

Table 1: Test area assessment of significant scrutiny companies

	Our assessment			
Test area	**Thames Water**	**Southern water**	**Hafren Dyfrdwy**	**Affinity Water**
Engaging customers	C	C	C	C
Addressing affordability and vulnerability	C	B	D	C
Delivering outcomes for customers	C	C	D	C
Securing long-term resilience	D	D	D	D
Targeted controls, markets and innovation	C	C	C	C
Securing cost efficiency	D	D	B	C
Aligning risk and return	C	C	D	D
Accounting for past delivery	D	D	D	C
Securing confidence and assurance	C	C	C	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

As part of our initial assessment we provided specific actions for each company that we expected them to address, in the most part, in a revised business plan submitted by 1 April 2019. However, some actions had later completion dates, for example actions on resilience plans are due in August 2019.

3. Our approach

In our PR19 methodology we explained that we would implement reduced cost sharing rates and potentially cap outcome delivery incentives in order to incentivise investors to hold companies to account, and so strongly incentivise companies to deliver high quality business plans. We wanted to protect customers of companies whose business plan was of poor quality, and did not give us confidence as a basis for setting price controls.

In modifying our approach in our Initial assessment of plans publication we want to ensure that companies retain incentives to respond positively to our feedback, work hard to engage on the key issues and deliver high quality responses. We want confidence that the companies have made substantive progress in addressing our actions, allowing us to have confidence in the information we use to set price controls.

To have confidence we consider each company's submissions 'in the round'. While the revised business plan is central to this, company responses to our queries and material submitted for later dated actions are all important to this. Similarly, the quality of the responses to the draft determination will be an important consideration.

So while we set out our current view on the four significant scrutiny companies in this document, our final view will consider both the company approach up to the draft determination, and also through to the final determination.

How we are assessing companies

We are not looking to re-run the initial assessment of plans and we will not re-assess each company against the nine test areas. The initial assessment of plans sought to incentivise high quality business plans from all companies. We are focusing on setting draft and then final price controls which means, in terms of our assessment, we primarily focus on whether the company is effectively addressing the actions we identified, any new information it is providing to us and the quality of any new proposals it set out in its revised plan. To effectively address actions, companies need to respond to the actions in full, with clarity and where appropriate, supported by convincing evidence.

We also consider an 'in the round' view of the overall quality of a company's engagement with us. We want the four significant scrutiny companies to focus on the key issues identified, engage in an open and positive way. This helps to ensure customers are protected and is the best way for companies to ensure we understand their case.

In assessing each company we will be looking to answer two main questions summarised in Table 2. As part of the assessment we will consider a number of factors also outlined in the following table.

Table 2: Key factors in considering progress by significant scrutiny companies

Question	What we consider
Has the company effectively addressed actions identified?	• Are actions identified in the initial assessment of plans effectively addressed? • Were submissions complete and did they cover all the expected areas? • What is the quality of evidence provided, does it answer the questions posed and improve our understanding of an issue? • Were significant concerns or material errors identified in material submitted? • Were further material interventions required at draft determination?
What is the quality of the company's engagement?	• Has a company been open and sought to engage and address actions in a positive manner? • Has a company submitted material to us on time (and met our expectations)? • Has a company submitted new material late, that could reasonably have been identified and submitted at an earlier stage? • Have follow up responses been required due to a lack of clarity or errors in submissions?

In reaching a view we will consider whether companies are making substantive progress, partial progress or no progress in addressing the actions from the initial assessment of its plan.

4. Our current view

We are pleased that all four significant scrutiny companies have sought to address the initial assessment of plans actions in their April business plan resubmissions and their approach has, on the whole, been positive. However, the quality and extent to which each company has responded to each of its actions and the way it has engaged with us in the period leading up to the draft determinations has varied. This is reflected in the progress each company has made in addressing its actions and the extent to which material interventions are still required in the draft determinations.

We set out our current view of each company below in relation to the cost sharing rate.

Subject to how companies respond in the remainder of the process, we do not currently intend to apply an outcome delivery incentive cap for any of these four companies.

In our PR19 methodology we said that we would consider capping, including down to zero, the outcome delivery incentive outperformance payments on bespoke performance commitments for a company categorised as being under significant scrutiny in the initial assessment of business plans. This was because for bespoke performance commitments data quality will depend on information provided in the significant scrutiny company's business plan.

We do not have sufficient concerns to disallow outcome delivery incentive outperformance payments for significant scrutiny company bespoke performance commitments in the round. We will address specific concerns with evidence for outcome delivery incentive outperformance payments when we set company outcome delivery incentive rates.

Affinity Water

Since the initial assessment of plans, Affinity Water has provided evidence of varying quality and in some cases has not fully responded to its actions with multiple queries required to gain a better understanding. It has positively engaged with us to date and has provided evidence that it has taken account of our feedback. We have seen the company make good progress towards addressing some of the actions identified at the initial assessment of plans, in particular by:

- increasing the number of performance commitments from 19 to 28, including adding 5 resilience performance commitments;
- increasing the level of stretch it is proposing to its common performance commitments; and
- reducing its enhancement totex and retail costs to more closely align with our view of efficient costs.

However, there are still a number of areas in its draft determination where further material interventions are required:

- although it has reduced its level of total expenditure in its April resubmission and reduced the gap compared to the initial assessment of plans, there is still a 8.3% cost efficiency gap. We were not convinced by the companies cost adjustment claims;
- we are reducing its proposed pay as you go and regulatory capital value run off rates as it provided insufficient evidence of customer support for use of pay-as-you-go (PAYG) rates to bring customer revenue forward into 2020-25 period resulting in higher customer bills;
- we are reducing the net price review 2014 reconciliations due to insufficient evidence which has been the subject of four separate queries;
- we have material concerns about the company's approach to financeability, where its business plan targets an average adjusted cash interest cover ratio for the notional company of at least 2x which far exceeds the level required for the target credit rating; and
- we are seeking further assurance about the company's plans to maintain financial resilience in 2020-25 in the context of poor financial ratios for its actual financial structure in its business plan.

It also provided research into its customer's willingness to pay late and in several stages so not all of this research could not be taken into account in our assessment of some of its performance commitments in its draft determination.

The Affinity Water actions and interventions company documents set out in detail those actions where the company did not provide convincing evidence and where further material intervention is required at the draft determination. There are still some interventions which have a material impact on customers.

We expect Affinity Water to focus on effectively addressing the actions and interventions we have identified in its draft determination by providing timely, high quality evidence in its representations in August and engaging positively ahead of the final determinations in December 2019.

We consider that, for us to not apply the reduced cost sharing rate, Affinity Water needs to make further progress in addressing our concerns through timely, high quality response to draft determination.

Hafren Dyfydwy

Hafren Dyfydwy has positively engaged with us since the initial assessment of plans and it has provided evidence that it has taken account of our feedback. We have seen significant progress in the company addressing the actions we identified, in particular:

- it has increased the level of stretch to its per capita consumption performance commitment;
- its outcome delivery incentive package creates a mix of incentive types which include customer protection measures; and
- it has introduced a new source resilience metric to provide assurance on the resilience levels within its asset configuration.

However there remain a small number of areas where further minor interventions are required:

- We are amending and adjusting outcome delivery incentives for some of the performance commitments, including leakage, sewer collapses, supply interruptions, pollution incidents, discoloured water contacts and internal sewer flooding. This is because the company did not provide sufficient evidence or diverged from the results of their own research; and
- We are increasing the reporting requirements on its pollution incidents in its annual performance report as it has not adequately evidenced that it has learnt from its past delivery performance.

The Hafren Dyfydwy actions and interventions company documents sets out in detail those actions where the company did not provide convincing evidence and further intervention is required at the draft determination. However, the number of interventions is small and of limited material impact on customers.

We expect Hafren Dyfydwy to focus on effectively addressing the actions and interventions we have identified in its draft determinations by providing timely, high quality evidence in its representations in August and engaging positively ahead of the final determinations in December 2019.

We consider that, subject to the company continuing to address our concerns through a timely, high quality response to our draft determination, we are not likely to apply a reduced cost sharing rate for Hafren Dyfydwy.

Southern Water

Southern Water has positively engaged since the initial assessment of plans and has sought to understand what is required and how to target its efforts in its April business plan resubmission. We have seen the company make good progress towards addressing the actions identified, in particular:

- its resubmitted plan included significant scope reductions and efficiency improvements which resulted in a material reduction in totex;
- it proposed more stretching common performance commitment levels, which we accept for the draft determination; and
- it provided good quality responses to our concerns and required actions in relation to past delivery.

However, there are still a number of areas in its draft determination where further material interventions are required:

- although it has reduced its level of total expenditure in its April resubmission and significantly reduced the gap compared to the initial assessment of plans, there is still a 7.8% cost efficiency gap;
- we intervene in relation to the company's proposals to bring forward £182m of revenue from future customers as the evidence provided was not convincing;
- we have some concerns about the extent and consistency of the company's approach and engagement on strategic water resources. Its revised submission did not align with other companies' submissions, which included joint solutions not in Southern Water's revised plan; and
- we are adjusting or amending a number of outcome delivery incentive rates to protect customer interest including for leakage, per capita consumption, improving bathing water, treatment works compliance and pollution incidents, due to concerns over the quality of evidence provided. This is because the company provided low quality evidence or did not demonstrate customer support

The Southern Water actions and interventions company documents set out in detail those actions where the company did not provide convincing evidence and where further material intervention is required at the draft determination. There are still some interventions which have a material impact on customers.

We expect Southern Water to focus on effectively addressing the actions and interventions we have identified in its draft determinations by providing timely, high quality evidence in its representations in August and engaging positively ahead of the final determinations in December 2019.

We consider that, for us to not apply the reduced cost sharing rate, Southern Water needs to make further progress in addressing our concerns through timely, high quality response to draft determination.

Thames Water

Since the initial assessment of plans, Thames Water has provided evidence of varying quality in response to its actions. We have seen the company make some progress towards addressing the actions identified, in particular:

- its resubmitted plan included some scope reductions and efficiency improvements which resulted in a material reduction in totex; and
- it proposed a company specific gearing sharing mechanism.

However there are still a number of areas in its draft determination where further material interventions are required:

- although it has reduced its level of total expenditure in its April resubmission and significantly reduced the gap compared to the initial assessment of plans, there is still a 15.7% cost efficiency gap;
- we are intervening to propose more stretching targets for several of its performance commitments e.g. leakage, internal sewer flooding and water supply interruptions
- we are increasing the stretch on some common performance commitments to reach upper quartile, including increasing the proposed reduction in leakage from 20% to 25% to reduce the gap to the rest of the industry;
- we are intervening to decrease its net price review 2014 reconciliation revenue by £150m, which is largely as a result of the cancelled Counters Creek sewer flooding programme; and
- we are intervening to introduce the gearing benefit sharing mechanism set out in our 'Putting the sector in balance' position statement to ensure customers get fair share of benefits from Thames Water gearing levels.

Thames Water also provided some material late which meant it may not have been possible to take this into account in the draft determination. The evidence it provided late was in relation to its direct procurement for customers approach in respect of which it also did not provide the requested value for money assessments, its customer preferences research and its stakeholder engagement summary report.

The actions and interventions company documents sets out in detail those actions where the company did not provide convincing evidence and where further material intervention is required at the draft determination. There are still a number of interventions which have a material impact on customers.

We expect Thames Water to focus on effectively addressing the actions and interventions we have identified in its draft determination by providing timely, high quality evidence in its representations in August and engaging positively ahead of the final determinations in December 2019.

Our view is that, for us to conclude that a reduced cost sharing rate should not apply, Thames Water has substantially more progress to make in addressing our concerns through a timely, high quality response to our draft determination.

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.

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.gov.uk

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