August 2014

Setting price controls for 2015-20
Draft price control determination notice: technical appendix A7 – financeability and affordability

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Overview

This document sets out the approach to financeability and affordability we have used in setting the draft determinations for the five years from 1 April 2015 and summarises the results of our review of companies' business plans.

Consistent with our wider approach to PR14, we require companies to demonstrate that their business plans are able to finance their functions, and that their plans are affordable both over the period 2015-20 and the longer term.

The key results of our review of the companies' business plans are as follows.

- Overall, there is a high level of customer support for the affordability of bills. Many companies have reduced bill levels since the December plans, which is likely to improve further the affordability of their plans. All companies have provided Board assurance that they were financeable on an actual and notional basis.

- The methodology allows companies to use new tools to balance the proportion of costs recovered within the period 2015-20 and the amount recovered over a longer period, in consultation with CCGs. Most companies have chosen to use these tools.

- There are a small number of areas where we consider it necessary to intervene to protect customer interests. These are:

  - requiring third party assurance on financial data and financeability from four companies as our review revealed errors in the financial data which undermine the reliance that can be placed on previous assurances around financeability;
  - intervening in the PAYG and RCV run off ratios for two companies due to insufficient evidence that the use of the levers is in customer interest; and
  - asking a number of companies to engage with their CCGs on the balance between the interests of current and future customers in the pass through of the benefits of the WACC reduction.

The material we have published today sets out our draft proposals. Stakeholders now have the opportunity to comment on the proposals and the approach we have adopted in reaching our decision. We will consider carefully all of the representations ahead of making final determinations in December. In particular, companies will review whether to include further evidence as a result of the feedback we have given them. And we will maintain our high evidential bar to make sure that our final decisions represent the best possible deal for customers.

A7.1 Introduction

In this chapter, we consider how the different price controls come together in terms of their impact on:

- customer bills, both today and in the future (affordability); and
- companies' ability to finance their functions (financeability).

Both considerations are important for how Ofwat and companies meet their statutory and legal obligations. We set out our approach to financeability and affordability in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'final methodology statement').

The methodology allows companies to use new tools in the form of PAYG rates (the proportion of totex recovered in the period 2015-20) and RCV run-off rates (depreciation of the RCV). Both PAYG and RCV run-off rates can be adjusted to change the proportion of costs recovered within the 2015-20 period and the amount added to the RCV and recovered over a longer period. Adjustments to PAYG/RCV will therefore impact on customer bills in the period 2015-20 and beyond 2020. Similarly, adjustments to PAYG and RCV run-off rates can help companies address financeability constraints by increasing revenue in 2015-20 period. We consider that it is essential that companies continue to engage with CCGs and their customers on the use of these tools and to consider the implications for affordability in the period 2015-20 and in future periods.

This appendix sets out our approach to financeability and affordability, and sets out issues that have arisen in reaching our draft determinations. Finally, we discuss our approach to bill profiling for our draft determinations.

A7.2 Financeability

One of our statutory duties is to enable an efficient company to finance its functions. We interpret the financing duty as applying to the ring-fenced regulated activities of the appointee, and – consistent with our long held policies in respect of setting price limits – we interpret this duty to require that we ensure that an efficient company with a notional capital structure can:

- earn a return at least equal to our allowed costs of capital; and
- raise finance on reasonable terms.

Consistent with our wider approach to PR14, we require companies to demonstrate that their business plans are financeable.

As we stated in our final methodology statement, we assess how companies have demonstrated their financeability by considering:

1. financeability (and financial ratios) at a whole company level – using aggregated revenues, costs and cash flows associated with efficient delivery of regulated activities across all the price controls;
2. whether proposals for controls are self-financing in their own right; and
3. whether proposals represent a fair balance between the interests of the company and its customers.

As set out in our final methodology statement and information notice 'IN 14/11: 2014 price review – Ofwat's approach to assessing financeability', we asked companies to demonstrate that they can finance their activities by providing financial ratios in their business plans at the appointee level on an actual and notional capital structure (with gearing and cost of debt consistent with our financial guidance and, a 33% weighting of index-linked debt). We also asked companies to explain how these ratios are consistent with their target credit ratings. In addition, we invited companies to provide additional evidence on financeability such as third party assurance or evidence from rating agencies and lenders.

Our focus is on the financeability of the notional company as this ensures that risks around financing decisions, such as the level of gearing and structure of debt, remain with the company rather than being passed onto customers. It is appropriate for the company to consider use of PAYG and RCV run-off rates to address financial constraints for the notional company, if they exist. Changes to PAYG and RCV run-off rates will impact on customer bills, so it is important that companies explain to their CCGs and customers the proposed changes and how they propose to balance the company's financeability requirements and customers' interests.

We do not consider it appropriate for the company to use PAYG and RCV run-off rates to address financeability issues arising from the actual financing arrangements of a company. For example, a company more highly geared than the notional company gearing of 62.5% may experience financeability issues which would not affect the notional company. This is an issue for the company's shareholders to address (such as through a reduction in, or suspension of, dividends and/or equity injections).

The next section sets out companies' evidence of their financeability. This includes:

- Board assurance of their financeability;
- financial ratios;
- evidence of customer support and benefits for use of PAYG and RCV run-off rates.

A7.2.1 Board assurance of financeability

All companies provided Board assurance that they were financeable on an actual and notional basis. Thames Water and United Utilities provided third party assurance of their financeability. A number of companies provided additional ratios or alternative calculations of the ratios to those set out in our final methodology statement. We have reviewed the evidence provided by companies, including their financial ratio calculations, and have calculated the ratios based on our modelling for both the company business plan and our draft determinations (using our financial model).

There are four companies for which we are seeking third party assurance on the financeability due to serious issues with the quality of the financial information presented in their plans and, in two cases, concerns about individual ratios. The table below sets out our concerns and our expectations for further assurance.

Table A7.1 Further assurance on financeability

Companies	Concerns and actions
Dee Valley and South Staffordshire	Third party assurance on financeability and calculation of the financial ratios to address issues with the quality of the financial data and ratios presented in their June business plans.
Portsmouth	To consider financeability of actual company in light of their revisions which materially reduce their FFO/debt ratio, and to provide third party assurance on their financeability and calculation of financial ratios.
Sutton & East Surrey	To consider financeability in light of draft determination interventions, in particular with regard to the ACICR ratio which is materially lower than proposed in business plan, and to provide third party assurance on their financeability and calculation of financial ratios.

Financeability ratios

The table below summarises the results of Ofwat's financial modelling of company draft determinations for three credit ratios. These ratios were defined in Ofwat's methodology statement. They are similar to ratios used by rating agencies; however, we note that rating agencies consider a range of evidence in the assessment of credit ratings and do not rely on the ratios alone. They may also place different weights on various ratios and use alternative ratios or definitions of some ratios. They are focused on the credit rating of actual issuances rather than the notional company. A full set of Ofwat ratios is set out in each draft determination along with a discussion of financeability for each company[1].

As set out in our final methodology statement, we consider financeability before adjustments to revenues that reflect performance over 2010-15, as this approach preserves incentives on companies and ensures that the focus is on the underlying financeability of the business. Our draft determination ratios are calculated on the basis of an efficient notional company, which assumes that companies are able to deliver their plans based on the allowed expenditure in the draft determination.

[1] The regulatory equity/regulatory earnings ratio is now defined on the basis of earnings after real interest and tax; previously, this has been defined on the basis of nominal interest for the early draft determinations. The use of real interest is more consistent with this measure as an economic measure of equity returns.

Table A7.2 Ofwat calculation of selected financial ratios for the notional capital structure for draft determinations

Company	ANH	SRN	SVT	TMS	UU	WSX	YKY	BRL	DVW	PRT	SBW	SES	SEW	SSC
ICR	2.84	3.41	3.12	2.82	3.19	3.24	2.84	3.74	3.25	2.64	3.27	3.47	2.88	3.59
AICR	1.46	1.49	1.60	1.40	1.61	1.76	1.64	1.85	1.50	1.32	1.88	1.22	1.73	1.46
FFO/debt	8.7%	11.3%	9.9%	8.6%	10.2%	10.5%	8.7%	13.0%	10.9%	8.1%	11.2%	11.6%	8.9%	12.3%
Gearing	62.3%	61.9%	63.0%	64.3%	59.9%	63.5%	60.8%	64.7%	67.7%	62.1%	60.9%	64.5%	62.9%	66.9%

Note:

The ratios for Severn Trent include their resilience scheme.

Key:

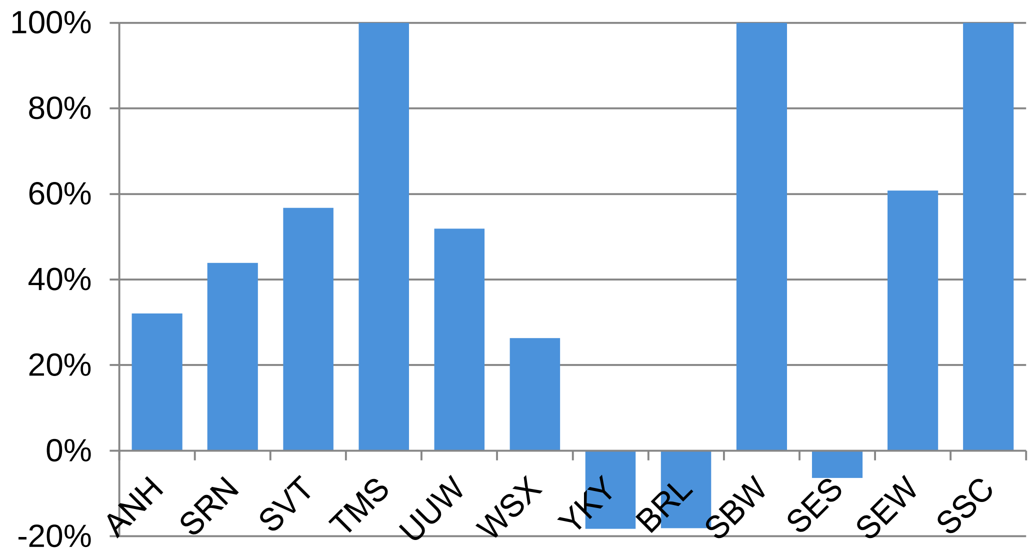
ANH = Anglian Water; SRN = Southern Water; SVT = Severn Trent Water, TMS = Thames Water; UU = United Utilities; WSX = Wessex Water; BRL = Bristol Water; DVW = Dee Valley Water; PRT = Portsmouth Water; SBW = Sembcorp Bournemouth Water; SES = Sutton & East Surrey Water; SEW = South East Water; SSC = South Staffordshire Water.

Balancing company and customer interests

We have assessed whether the companies' proposals (including use of PAYG and RCV run-off levers) represent a fair balance between the interests of the company and its customers.

Figure A7.1 sets out companies proposed pass through of the WACC reduction between their December business plans and their June business plans to 2015-20 customer bills, taking account of our risk and reward guidance in January. It should be noted that all water and sewerage companies (WaSCs) accepted the risk and reward guidance in their June business plan resubmissions, while all water only companies (WoCs) except Affinity Water proposed a company-specific uplift on the cost of capital. In some cases, such as Portsmouth Water and Dee Valley Water, their proposed cost of capital has not changed since December, while for others it has been reduced but by a much smaller amount than WaSCs. Therefore, the level of pass through of the WACC reduction is less relevant for WoCs and needs to be considered in conjunction with our decision on the company-specific uplift and their allowed WACC in the draft determinations.

Figure A7.1 WACC reduction between December and June business plans passed through to customers in 2015-20 period



Note:

Dee Valley and Portsmouth Water did not reduce the WACC between the December and June business plans. For all companies the proportion of WACC reduction passed through will vary from the impact on bills as companies will have made other changes to their business plan.

To assess whether company proposals represent a fair balance between the interests of the company and its customers we have considered whether:

- the company's financial ratios are materially above financeability requirements;
- the company has used PAYG/RCV run-off levers to offset the reduction in the cost of capital since December; and
- there is customer support for the company's use of PAYG/RCV run-off levers.

On the basis of these criteria, we have intervened in two companies' plans for the following reasons.

- Yorkshire Water –the company had used PAYG and RCV run off levers to remove all of the impact of the WACC reduction in 2015-20 with little evidence that this approach being beneficial to customers; there was also limited CCG engagement, which was on the basis of the actual rather than notional company.

- Sembcorp Bournemouth Water –the company had used a high PAYG ratio (in relation to 2020-25 rate), which results in higher bills in 2015-20 period, to maintain stable bill profile over the 2015-25 period (i.e. across two price controls). This has the impact of increasing bills and benefiting financeability ratios over 2015-20 period compared to the level of bills and ratios with stable PAYG rate over both periods. Sembcorp Bournemouth Water provided little evidence that this approach is beneficial, nor that it has informed support from its customers.

For Yorkshire Water, we have reset the PAYG/RCV run-off levers to their level in the December plan. For Sembcorp Bournemouth Water, we have reset PAYG based on the average level of opex and IRE in the period, which is broadly consistent with its view of appropriate PAYG level beyond 2020. If either of these companies propose further adjustments to these ratios then they should engage with their CCGs on the proposed changes and explain why they are in customers' best interests.

We are also asking the following companies to re-engage with their customers where they have provided satisfactory evidence on the benefits to customers from the use of the financeability tools but have not provided satisfactory evidence on engagement with customers: Anglian Water, Severn Trent Water, Southern Water, United Utilities and Wessex Water.

As all WoCs sought a company-specific uplift, the pass through of the WACC reduction needs to be considered in conjunction with the decision on these uplifts in the draft determinations. Sembcorp Bournemouth Water and Portsmouth Water are receiving a lower uplift than proposed in their business plans, while Bristol Water, Dee Valley Water, Sutton & East Surrey Water, South East Water and South Staffordshire Water are not receiving any uplift. We have not made adjustments to PAYG rates for these companies, so the benefits from removing or reducing the company-specific uplift will be passed through to customers in 2015-20.

Companies will be able to consider the impact of these changes and their pass-through of earlier WACC reductions and should engage with customers on any proposed use of PAYG levers in response to the draft determinations.

A7.3 Affordability

As set out in our final methodology statement, our approach to affordability has been to assess how well companies have demonstrated their plans are affordable both over the 2015-20 period and the longer term.

In assessing current and future affordability, we have considered the following.

- Company evidence on affordability from their customer surveys, customer acceptability scores and CCG engagement.
- Companies' identification, based on their evidence, of affordability issues for customers and the development of appropriate measures to address the affordability issues for these customers.
- The impact on bills in 2015-20 and in the future from the use of financeability levers to bring forward or push back revenue between price control periods.
- The potential impact of ODI penalties and rewards on affordability.

In their business plans, many companies provided strong evidence of effective engagement with customers over the acceptability of the plans and proposed bill levels, and proposed a range of measures to address the concerns of customers who faced affordability issues, see table below. Since the December plans, many companies have also reduced bill levels further, which is likely to improve the acceptability of their plans.

As part of our approach to PR14, we have placed responsibility on companies to engage with their customers on the affordability of their business plans and to use the results of this engagement to modify their plans and target assistance to those facing affordability issues. In our risk based review, we noted the effective engagement by a range of companies across the sector. The table below sets out a few selected examples of how companies have responded to the challenge of developing affordable plans for their customers.

Table A7.3 Examples of measures taken by companies to identify and address affordability concerns

Issue	Examples
Inclusive customer engagement	Anglian Water engaged with a representative sample of its customers ensuring it captured the views of vulnerable customers both in its main surveys and by running targeted focus groups. The company also completed ethnographic research observing customers in their own homes again ensuring this included vulnerable customers.
Understanding affordability constraints	United Utilities identified clear differences in acceptability tests of its plans by income, with customers earning up to £15,499 per annum finding its plans significantly less acceptable than those earning £15,500 and over.
Targeting assistance to those in need	Southern Water developed a priority order of interventions that comprised of; bespoke home water efficiency audits including installations of new devices; financial health checks and money advice (including benefit entitlement checks); a social tariff offering discounts of between 20 to 90%; and general financial assistance schemes.

In the risk-based review, we identified concerns with the evidence provided by six companies on the affordability of their plans: Bristol Water, Dee Valley Water, South East Water, South Staffordshire Water, Sutton & East Surrey Water and Thames Water.

These companies responded positively to our risk-based review concerns and made improvements to their plans. Sutton & East Surrey Water and South East Water have provided sufficient evidence that they had conducted new research which has addressed our concerns over their engagement with customers on the impact of the Thames Tideway Tunnel project on the acceptability of bills. Dee Valley Water and South Staffordshire Water presented revised research which addressed our concerns on the presentation of their bills. Bristol Water provided new research justifying its cost recovery approach, which we had highlighted as an area for improvement at the risk-based review.

Thames Water has conducted further research which has addressed our concern with their customer research on the acceptability of their plan. This research has identified significant customer concern about the impact of the Thames Tideway Tunnel on the acceptability of the bills. In response to these issues, Thames Water has proposed additional measures to assist customers with affordability issues, including the provision of a £10 million tax credit to its Customer Assistance Fund, which helps customers in arrears to become regular payers. These changes take direct customer support measures in 2015-20 from around £12 million to around £22 million.

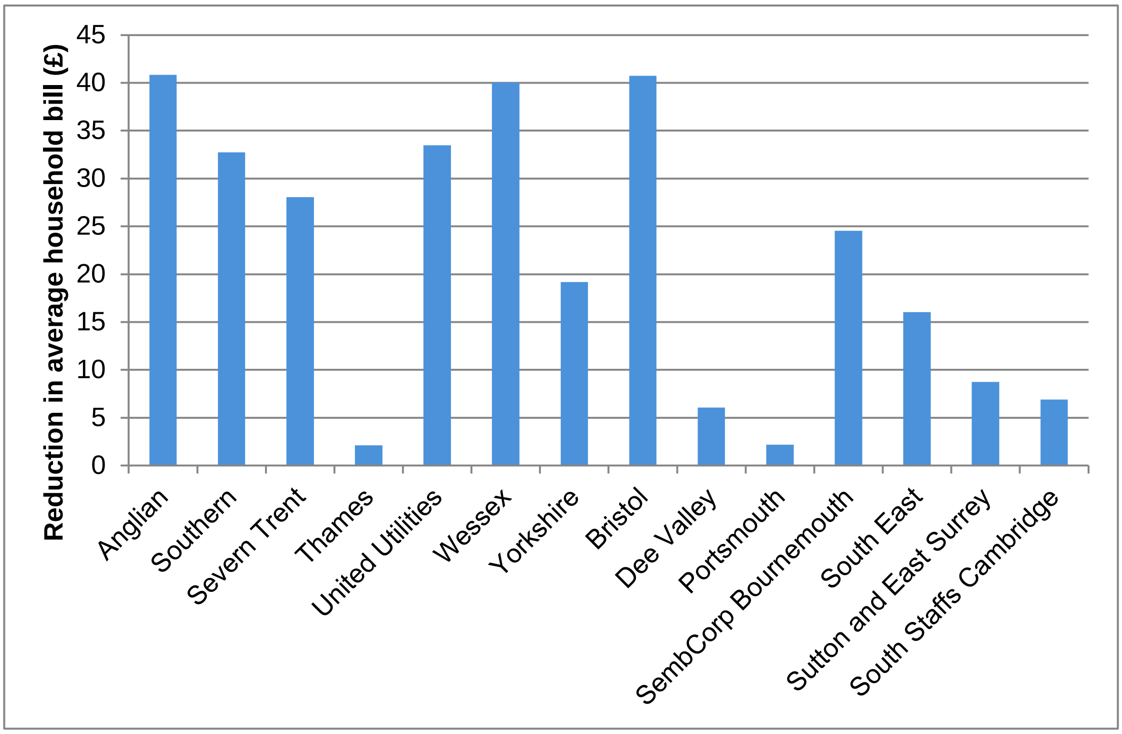
The communications with customers on the impact of the Thames Tideway on bills in 2015-20 and beyond will be critical given the concerns identified over the impact on Tideway on affordability. Thames Water, along with Affinity Water and South East Water, have committed to working with their CCGs to engage with customers on this issue. We have also asked Sutton & East Surrey Water to include a similar approach to engaging with its customers and CCG on this issue.

As outlined above, the use of PAYG levers by Sembcorp Bournemouth Water raises concerns about the increase in bills in 2015-20 in order to maintain stable bills across the 2015-25 period. We have reset the PAYG rate consistent with a stable level of PAYG ratio over 2015-20 and 2020-25 and this has reduced bills in 2015-20 period. If Sembcorp Bournemouth Water wishes to consider revising these rates, we invite the company to engage with customers in order to gain customer support for any proposed increase in bills through the use of the PAYG lever.

A7.3.1 Impact on bills

We estimate that based on the 14 draft determination, the average household bills of customers will be reduced by £24 per year from 2010-15 to 2015-20. We note that that allowed revenues and customer bills may change between draft and final determination, particularly for the three companies where have identified significant differences between their June business plans and our draft determinations.

Figure A7.2 Reduction in average household bills between 2010-15 and 2015-20



Note:

For WaSCs this is combined bills and for WoCs this reflects water only bills. We have identified significant outstanding issues with cost baselines for three companies: United Utilities, Thames Water and Bristol Water and bill changes for these companies should be considered as indicative only. Thames Water bill does not include impact of Thames Tideway infrastructure provider costs.

A7.4 Bill profiling

The overall impact of our interventions in companies' business plans will be to affect both the level of the bill and the profile of the bill (that is, the way that the bill changes) over the 2015-20 period. The impact on the profile of the bill will depend on the nature of our interventions.

We have considered the results of our interventions on the bill profile for each company and have re-profiled bills where interventions resulted in significant changes in the bill level, as company's proposed bill profile may no longer be relevant in these cases. For example, a company may have proposed a flat profile as its plan had little change in allowed revenues, whereas Ofwat interventions may result in a falling bills. We expect all companies to engage with their customers on bill profiles in draft determinations and provide evidence of customer support for any proposed changes. A summary of bill profile interventions is set out in the table below.

Table A7.4 Summary of bill profile interventions in draft determinations

Company	Bill profile intervention
Southern, United Utilities, Wessex, Yorkshire, Bristol, Dee Valley, South East , South Staffordshire	Re-profile to take bill reduction in the first year with broadly flat bills for the remainder of the period. This equalises the customer benefits across the period and avoids the risk of an unduly low bill at the end of the period and consequent implications for bill changes in PR19 period.
Portsmouth	Re-profile to provide a flat bill profile consistent with the Portsmouth Water business plan by removing the decrease in 2015-16 and subsequent increase in 2016-17 that resulted from initial draft determination model run.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water sector in England and Wales provides customers with a good quality and efficient service at a fair price.

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