Information notice

www.ofwat.gov.uk

2014 price review – Ofwat's approach to the assessment of risk

This information notice sets out further information for companies on how to address risk as part of their business plan submissions in June. It is based on our experience with early draft determinations and common queries. This information notice relates to table A20 of the business plans and supporting evidence.

This is part of our 2014 price review.

The 2014 price review is our process for setting the price and service packages ('price controls') that each monopoly company must deliver over the five years between 2015 and 2020.

Background

In appendix 5 of 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology'), we set out our expectations for company business plans. In January, we published 'Setting price controls for 2015-20 – risk and reward guidance' (our 'risk and reward guidance'), which set out how we would assess the appropriate balance of risk that companies should be taking and those which customers will be bearing.

We also provided more information on this when we announced the results of our risk-based review of companies' business plans on 10 March, and the workshops we held on 7 April and 9 April.

Companies should provide information on their expected return on regulatory equity (RoRE) for a single scenario highlighting uncertainty around expected returns over the five years between 2015 and 2020. RoRE is a measure of the return that the company earns.

Information requirements for the assessment of risk

Before companies send us their revised business plans for the August draft determinations, we would like to highlight the following key areas to provide additional clarity of our expectations for them.

Use of the risk assessment tool

We ask companies that use the risk assessment tool to send us a completed version as part of their business plan submission. Those companies that have carried out their own analysis of risks are required to provide a reconciliation between their results and results obtained using the risk assessment tool. Such a reconciliation is required to explain the source and rationale for any differences.

Indicative ranges

In our risk and reward guidance, we set out our views about the RoRE range we are expecting to see, as well as the magnitude of the key components of the RoRE range.

- Overall RoRE range: ±3.5% to ±4.5%.
- Cost performance: at least ±2.0%.
- Outcome delivery incentives: ±1.0% to ±2.0% (upside at least 1.0%).
- Service incentive mechanism: -1.0% to +0.5%.
- Financing risk: ±0.1% to ±0.5%.

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

These ranges are not mandatory, given that the range for any component depends on the characteristics of a particular business plan. We expect that companies provide evidence of why elements of their business plans involve more or less risk.

For example, a company may submit a cost performance range below ±2.0% because it has identified that historic outperformance variation against operating expenditure (opex) and capital expenditure (capex) amount to a percentage of RoRE less than 2%, and that this is likely to represent a reasonable basis for estimating future cost performance variance. To help us assess this, we expect the company to provide supporting evidence, based on:

- historic cost variation;
- the cost risk that comparable companies experienced; and/or
- reasons why future cost variations will differ from historic levels.

We expect companies to provide sufficient detail so that we can understand the basis for their calculations and the evidence in support of their estimates.

Similarly, on outcome delivery incentives, we expect companies to provide supporting evidence if they fall outside the expected upside of 1-2% of RoRE. While it may be appropriate to submit an outcome delivery incentive package on this basis, the company should set out why it considers that the remaining potential rewards provide sufficient and appropriate incentive for outperformance.

Inflation

As we set out in our methodology, and as PwC set out in 'Economic assumptions for PR14 risk analysis', published alongside the methodology, scenario I includes a variation of Retail Prices Index (RPI) inflation. We note that wholesale revenues are indexed to RPI while retail revenues are not. Companies should provide clear evidence on the impact of expected variations in RPI on their expected returns.

For example, this might include the upside return from higher than expected RPI as wholesale revenues increase but wholesale costs may not increase at same rate. Companies should provide evidence for their view on expected impact on costs and returns from RPI variance.

Tax

For the avoidance of doubt, the ranges set out in our risk and reward guidance, which are quoted above, are on a post-tax basis. The risk assessment tool also calculates them on that basis.

Gearing

Historically, we have incorporated the notional gearing level into our financial modelling by fixing the level of gearing at the level assumed for the start of the 2015-20 period, and then letting subsequent gearing levels depend on each company's cash flow profile over the period. But the risk assessment tool differs from this approach as the level of gearing is fixed at 62.5% throughout the 2015-20 period, while the price review financial model uses, as a default, the same approach as past financial models (although this can be adjusted).

We are aware of this difference, and we accept that this results in slightly different RoRE numbers between the risk assessment tool and financial model. We propose to continue maintaining this approach as it reduces the complexity of calculating the RoRE range.

For the avoidance of doubt, the business plan table A20 submission should be calculated with the level of gearing fixed at 62.5% throughout the the 2015-20 period. But in order to ensure that the financial ratios for scenario I are comparable to the financial ratios submitted in table A8, the financial ratios in table A20 should be calculated with the level of gearing fixed at 62.5% only at the start of the period.

Evidence

Companies should submit:

- a business plan narrative discussing the results of their risk modelling; and
- the modelling files themselves.

In considering companies' submissions on risk, we require the best possible understanding of the assumptions made. The most convenient way for companies to allow us to do this is to submit their original calculations. Submitting all relevant workbooks at this stage will allow us to avoid unnecessary delays later in the process.

Uncertainty mechanisms

Companies should submit detailed information about each uncertainty mechanism in table W11 or S11 if they are proposing any additional ones beyond water business rates. They should also include a reconciliation between submissions in tables W11 and S11 and the amounts submitted in table A20. Specifically, the company should provide the information in lines 8, 9, 53 and 54 for each proposed uncertainty mechanism separately.

Enquiries

If you have any questions about this information notice, please send them to price.review@ofwat.gsi.gov.uk.

More information

'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', July 2013

'Economic assumptions for PR14 risk analysis', PwC, July 2013

'Setting price controls for 2015-20 – risk and reward guidance', January 2014

'Outcomes of the risk-based review and next steps', April 2014

'Outcomes of the risk-based review and next steps – financial modelling workshop: slides and questions and answers', 7 April 2014

'Outcomes of the risk-based review and next steps – outcomes, risk and reward workshop: slides and questions and answers', 9 April 2014

2014 price review web pages

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

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

May 2014

Sustainable water.

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 consumers with a good quality and efficient service at a fair price.