Information notice

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2014 price review – Ofwat's approach to assessing financeability

This information notice sets out further information for companies on the evidence of financeability we require them to submit as part of their business plan submissions in June. This draws on experience with early draft determinations and common queries.

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

Under section 2(c) of the Water Industry Act 1991 (WIA91), Ofwat has a statutory ('legal') duty to ensure that an efficient company can finance its functions. We call this 'financeability'. As part of the 2014 price review (PR14) process, we placed responsibility on companies to demonstrate their financeability in their business plans.

We set out this approach in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology'), which we published in July 2013. We will assess evidence that companies provide on their financeability (and financial ratios) at a whole company level – using aggregated revenues, costs and cash flows associated with regulated activities across all the price controls we set. Our methodology also set out the measures of return for individual price controls.

The financial ratios are similar to those used in previous price reviews. They are based on those typically reviewed by credit rating agencies for testing credit risk and the risk of default on debt.

As part of our assessment of the evidence that companies provide on their financeability, we will consider how their credit ratios are consistent with the target credit ratings that each company proposes. We will also compare the ratios in companies' business plan tables with the results we obtain from running our financial model for the actual and notional company.

At the workshop on modelling held on 7 April, we said that our assumed dividend policy for the notional company is 4% on equity at beginning of the 2015-20 period with a real growth rate of 1.65%. For modelling purposes, we assume that dividends are paid in the year that they are declared.

The notional capital structure assumes a proportion is comprised of index-linked debt. This does not impact the cost of debt assumption; but it does impact the profile of financing cash flows. Consistent with a single notional cost of capital, we propose to apply a consistent proportion of index-linked debt across the water sector in England and Wales.

As we set out in the published financial models for our draft

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.

determinations for South West Water and Affinity Water, the assumed level of index-linked debt is 33% of total debt. (We have reviewed the business plan submissions for the proportion of index-linked debt. While the average figure the industry proportion was closer to 40%, there is significant variation in the use of index-linked debt and we consider 33% a prudent assumption for the testing of financeability.)

Information requirements for assessment of financeability

Consistent with the approach for PR14, companies should take full responsibility for planning their business and the financeability of those plans. We set out the requirements for company submissions in appendix 5 of our methodology – 'Guidance on business plan tables' – and also in 'Setting price controls for 2015-20 – guidance on revised data table requirements following Ofwat's risk-based review'. We also provided further detail of the calculations in our financial model. 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.

Target credit ratings

We ask companies to set out target credit ratings for both the actual and notional company in their business plan table submissions.

Financial ratios

Companies should set out financial ratios under their actual and notional capital structure in table A8. They should explain how these financial ratios are consistent with their target credit ratings. The financial ratios under the notional capital structure should reflect the notional financial position of the business taking into account the notional level of gearing and the notional weighted average cost of capital (WACC). Companies are welcome to submit additional evidence of financeability such as calculation of additional ratios, if so, the full working for these calculations should be provided.

The notional financial position of the company should also take into account the notional cost of debt and the cost of equity embedded within the notional WACC. The financial ratios (but not the return on regulatory equity – RoRE – ranges) in table A20 should be set out on a consistent basis with those in the financial model – that is, gearing is set at 62.5% at the beginning of the period and allowed to vary in line with the notional dividend policy discussed above. The full set of financial ratios are provided in table 1 below.

Scenarios

Companies should set out the high and low scenarios for the financial ratios in table A20.

Board assurance

We require specific Board assurance on:

- the selection of target credit ratings;
- the calculations included in tables A8 and A20; and
- that the company is financeable on the basis of both the actual and notional capital structure.

Companies should provide Board assurance on the stress testing of the financial ratios, with the results of these stress tests set out in table A20.

Mitigating actions

Companies should set out:

- any actions taken to mitigate any financeability constraints;
- the underlying causes of any constraints; and
- the reasons why the approach taken is the most appropriate to their particular circumstances, balancing the needs of investors and customers.

Calculation details

Companies should provide their calculations of the financial ratios, including the calculations from the constituent components, as well as a narrative explaining the calculations.

Reconciliation items

Companies should reconcile the reasons for any differences in their own calculations of their financial ratios and those calculated by the Ofwat financial model.

Enquiries

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

Table 1 Measures of return, financial ratios and equity ratios considered in the financeability assessment

Measure	Definition	Used for
Financial ratios		
Cash interest cover	(Funds from operations + interest paid)/(interest paid)	Appointee
Adjusted cash interest cover ratio	(Funds from operations + interest paid – RCV depreciation)/interest paid	Appointee
Funds from operations/debt	Funds from operations/Average net debt	Appointee
Retained cash flow/debt	(Funds from operations – dividends paid)/net debt [using year-end net debt]	Appointee
Gearing	(Net debt)/(RCV) [calculated using year-end values]	Appointee
Equity ratios		
Dividend cover	(Profit after tax)/(Dividends)	Appointee
Regulatory equity/Regulatory earnings for the regulated company	(Average RCV - Average net debt)/(EBIT [calculated on a building blocks basis] - interest charge [including accretion of index linked debt] - tax	Appointee
RCV/EBITDA	Average RCV/EBITDA [calculated on an IFRS basis]	Appointee
Return measures		
Return on capital employed (RoCE)	Return due to providers of finance (EBIT – tax) [calculated on a building basis]/average RCV	Wholesale controls
Return on regulatory equity (RoRE)	Return due to shareholders/equity component of RCV assumed in notional capital structure [calculated on a building block basis] [Further detail is set out appendix 6.3 of our risk and reward guidance]	Wholesale controls
Retail net margin	EBIT [as % of end retail revenues]	Household retail control

Notes:

Funds from operations = Revenue-Opex-IRE expensed + Operating Income + Other Income-net interest paid-tax paid-changes in working capital (comprising inventories, trade and other receivables and trade and other payables).

Profit after tax is taken from the profit and loss on a normal accounting basis = Revenue less opex less IRE expensed less accounting deprecation plus operating income plus other income less net interest charge (including the accretion of index linked debt) less tax charge for the year.

More information

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

'Guidance on business plan tables', 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

'Setting price controls for 2015-20 – guidance on revised data table requirements following Ofwat's risk-based review', April 2014

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

2014 price review web pages

Companies' populated PR14 financial models

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Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.

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.

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