Aligning risk & return - webinar

14 February 2019

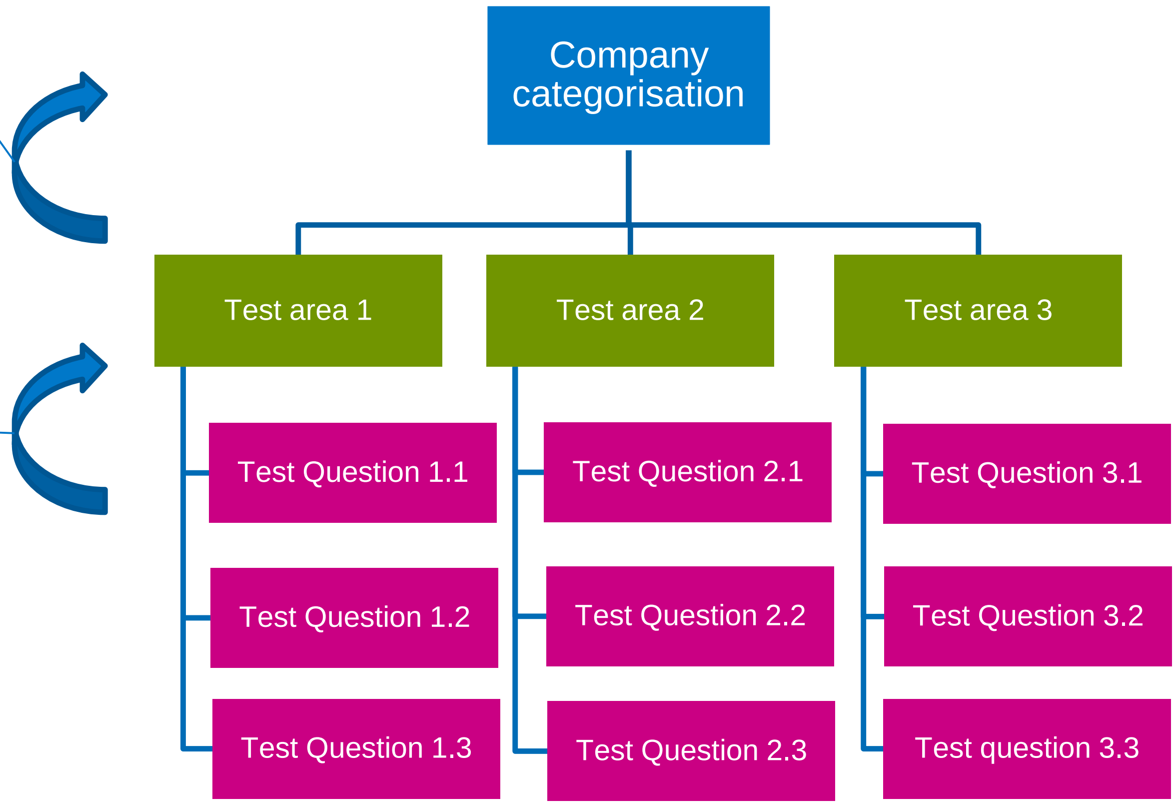
Initial assessment test areas

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

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.



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: • 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: • 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

Our approach to ‘aligning risk and return’, now and in the long term, supports the key themes of PR19. Our PR19 methodology incentivises all companies to improve their performance by aligning the interests of companies and investors with those of customers. This is so companies can push boundaries with their performance and improve customer service, while maintaining resilient services and affordable bills.

The risk and return test area is important for the following reasons:

- The cost of capital is a key driver of customer bills. We provided an early view of the cost of capital in the PR19 methodology, where companies depart from that in their business plans , it is important there is compelling evidence to support that different cost of capital.
- We expect companies to demonstrate a good understanding of risk and have good risk management processes in place. We expect this to underpin an assessment of the risks to equity returns measured as a return on regulatory equity (RoRE) for the notional financial structure.
- PAYG and RCV run-off are major drivers of customer bills, and so it is important that bill profiles that result from company choices of PAYG and RCV run-off rates are supported by customer preferences.
- We expect each company to submit a plan that is financeable, with Board assurance and supporting evidence that the plan is financeable on both a notional and the actual capital structure. This is important to ensure resilient services are provided to customers in the long term.

The risk and return test considers four questions:

Question 1 (cost of capital and retail margins): Has the company based the separate costs of capital that underpin each of its wholesale price controls, and the net margin(s) that underpins its retail price control(s), on those we state in our early view? If not, to what extent has the company robustly justified, in terms of benefits for customers, its proposed costs of capital and retail margin(s) within the context of expected market conditions for 2020-25?

Question 2 (managing risk and uncertainty – return on regulated equity (RoRE)): To what extent has the company demonstrated a clear understanding and assessment of the potential risks in its RoRE assessment, including the effect of the risk management measures it will have in place, across each of the price controls?

Question 3 (financeability): Has the board provided a clear statement that its plan is financeable on both an actual and a notional basis? Is the statement appropriate and how robust is the supporting evidence?

Question 4 (PAYG and RCV run off): How appropriate are the company's PAYG and RCV run-off rates? How well evidenced are they, including that they are consistent with customers' expectations, both now and in the longer term?

For this area, we only consider grades B to D. This is because innovation and ambition are not relevant to 'aligning risk and return'. The aggregation approach for the risk and return test area limits the maximum grade a company can achieve to its lowest scoring question from questions 1, 3 and 4.

Question	Water and sewerage companies											Water only companies					
	ANH	WSH	HDD	NES	SVE	SWB	SRN	TMS	UUW	WSX	YKY	AFW	BRL	PRT	SEW	SSC	SES
R&R test area	C	C	D	B	C	B	C	C	C	D	C	D	C	C	C	C	C
RR1	B	B	B	B	B	B	B	B	B	D	B	C	C	B	B	B	C
RR2	C	C	D	C	C	C	B	B	C	C	B	D	C	C	B	C	D
RR3	C	C	C	B	B	B	C	C	B	D	C	D	C	C	C	C	C
RR4	B	C	D	B	C	B	C	B	C	B	B	D	C	B	C	C	B

Cost of capital & retail margins

WACC & Retail Margins – What we were looking for:

Business Plans based on our Dec 2017 final methodology ‘early view’ of:

- Appointee WACC (2.4% RPI-stripped, 3.4% CPIH-stripped)
- Wholesale WACC (2.3% RPI-stripped, 3.3% CPIH-stripped) – for all controls
- Household net retail margins of 1.0%
- Business net and gross retail margins as applied at PR16; **OR:**

Different proposals to the above, justified in terms of:

- evidence on market conditions in 2020-2025.
- customer benefits
- customer preferences

WACC & Retail Margins - What we found:

Appointee:

- 12 companies based their business plans on our ‘early view’ appointee cost of capital.

- 5 companies proposed a higher cost of capital to our 'early view‘, justified by three due to their small size (see slide 10), and in two cases due to different input assumptions used to build up the WACC.'.

Wholesale:

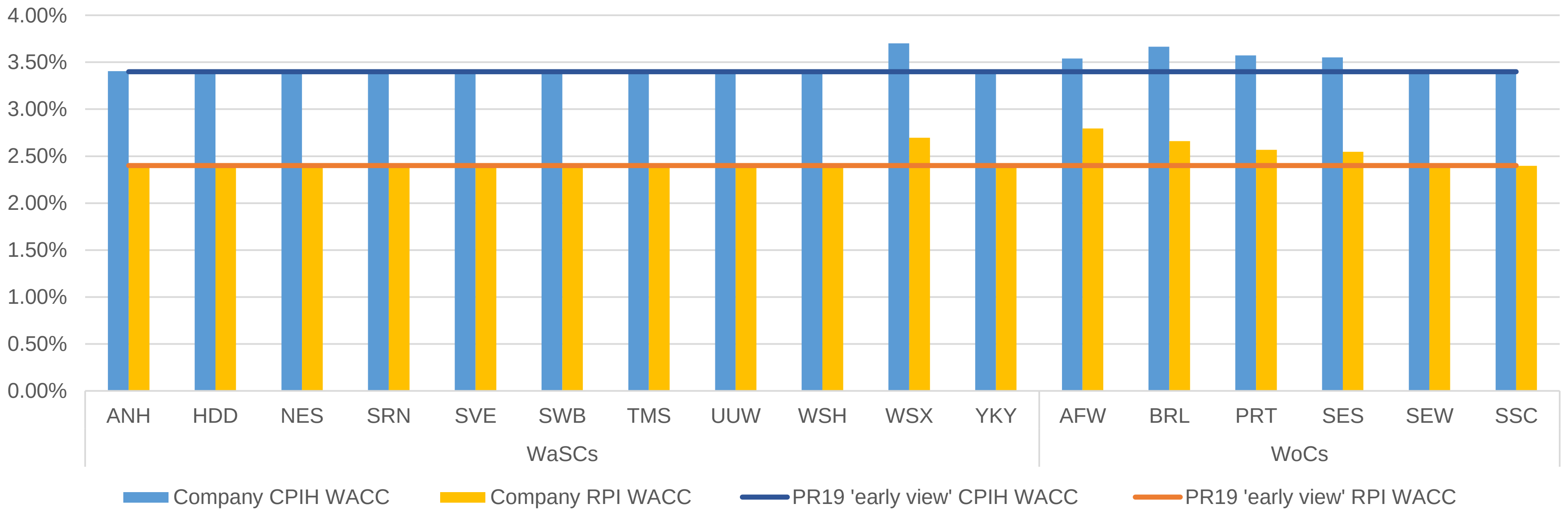
- No companies proposed a different WACC by control.

Retail Margins:

- All companies based their plans on our ‘early view’ household retail net margin of 1.0%.

- All three non-exited companies were in the round aligned with our ‘early view’ business retail margins. We assigned minor actions to two companies.

PR19 business plan submissions: Company cost of capital proposals:



Three small water-only companies proposed an uplift to their allowed cost of debt:

- Bristol Water: +0.45%
- Portsmouth Water: +0.30%
- SES Water: +0.25%

In assessing these proposals, we applied a three-stage approach from our Final Methodology, which asked the following:

1. Is there compelling evidence that the level of the requested adjustment is appropriate?
2. Is there compelling evidence that there are benefits that adequately compensate customers for the increased cost?
3. Is there compelling evidence of customer support for the proposed adjustment?

The results of our assessment:

Assessment	Bristol Water	Portsmouth Water	SES Water
Level of uplift:	Fail	Pass	Pass
Customer benefits:	Fail	Pass	Fail
Customer support:	Fail	Pass	Fail
Overall decision:	Fail	Pass	Fail

Risk and uncertainty

Risk assessment– what we were looking for

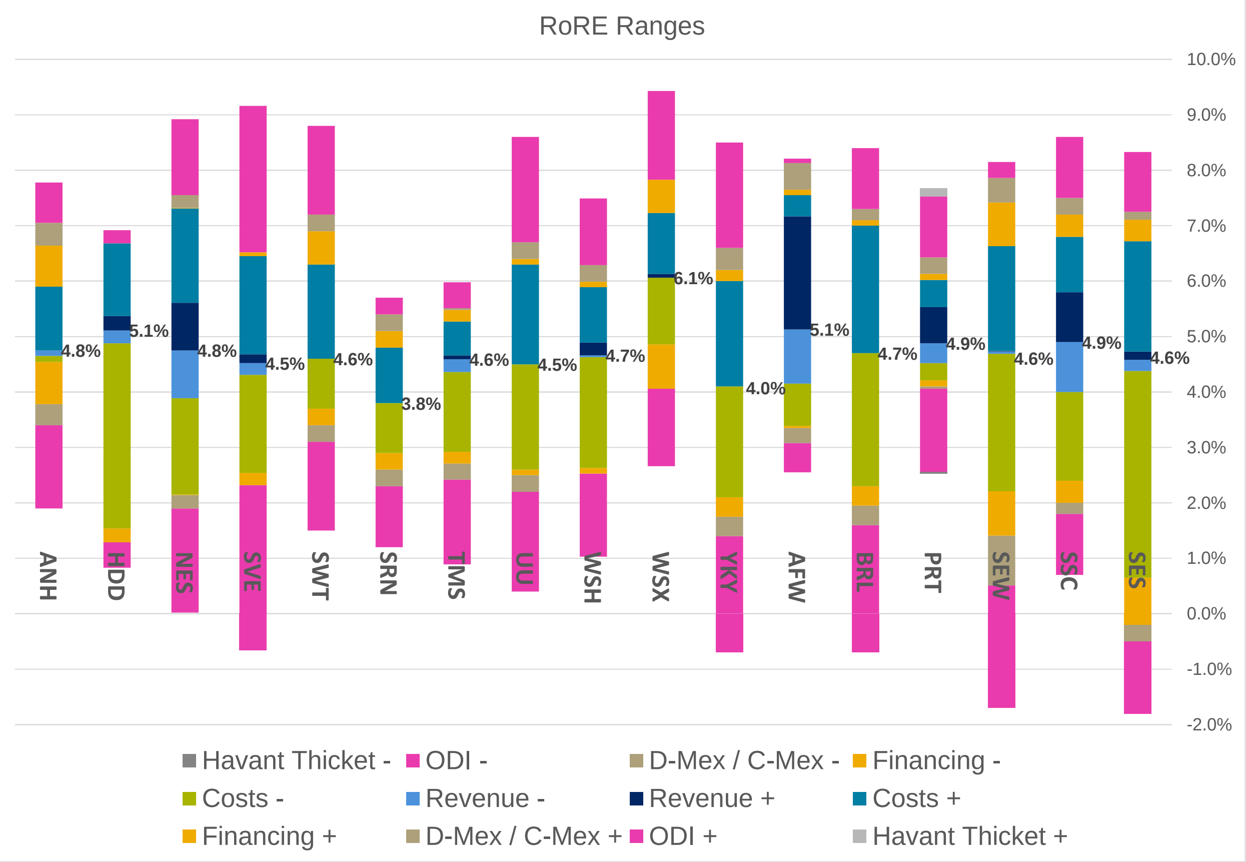
- PR19 methodology expects companies to demonstrate a clear understanding of risk and to provide clear evidence of risk management measures in place.
- As for PR14, we use of RoRE (Return on regulatory equity) as a measure of plausible financial risks at P90 (downside) and P10 (upside) confidence limits.
- We expect to see high and low case analysis for all seven prescribed scenarios (unless valid reason for omitting a scenario was explained).
- P90/10 values submitted in App26 with RoRE impacts shown on the dashboard tab of the PR19 financial model and in plan documents.
- Strong evidence of risk management/mitigation approaches for prescribed and any additional scenarios.
- Compelling evidence in support of any proposed uncertainty mechanisms, underpinned by RoRE analysis.

- Approach to ascertaining P90/P10 values generally good – several companies making use of monte carlo simulation.
- Insufficient evidence of risk management/mitigation measures in the RoRE analysis in some cases.

In some cases:

- Insufficient explanation of the reason for downside skew to totex risk ranges, which is not supported by evidence/historical data.
- Significant revenue risk ranges not supported by evidence in light of over/under-recovery provisions.
- Insufficient evidence that uncertainty proposals were underpinned by RoRE analysis.

We discussed these issues further in IAP [Technical appendix 3: Aligning risk and return]



Financeability

Credit ratings targeted for the notional and actual capital structures

As part of their business plan submissions, each company had to provide a clear statement that its plan is financeable on both an actual and a notional basis, with compelling supporting evidence. We assess the evidence supporting each company's board statement about the financeability of its business plan.
We asked companies to explain the credit ratings targeted for the notional and actual capital structures and the associated level of financial ratios which are required. The target credit ratings are set out below:

	Target credit rating for the notional financial structure		
Water company	Fitch	Moody's	Standard and Poor's
ANH	-	Baa1	-
HDD*	-	A3	A-
NES	-	Baa1	BBB+
SRN	-	Baa2	BBB+
SVE	-	Baa1	BBB+
SWB**	-	-	'Boundary of A/BBB+'
TMS	-	Baa1	BBB+
WSH	BBB	Baa2	BBB
WSX	'Robust investment grade'		
UUW	-	Baa1	BBB+
YKY	-	Baa1	-
AFW	-	Baa1	-
BRL	-	Baa2	-
PRT	-	A3	-
SES	-	Baa1	-
SEW*	-	Baa2	BBB
SSC	-	Baa2	-

	Target credit rating for the actual financial structure		
Water company	Fitch	Moody's	Standard and Poors
ANH	-	Baa1	-
HDD*	-	A3	A-
NES	-	Baa1	BBB+
SRN	-	Baa1	A-
SVE	-	Baa1	BBB+
SWB**	N/A	N/A	N/A
TMS	-	Baa1	BBB+
WSH	BBB+	Baa1	BBB+
WSX	'Robust investment grade'		
UUW	-	A3	BBB+
YKY	-	Baa2	-
AFW	-	Baa1	-
BRL	-	Baa2	-
PRT	-	Baa2	-
SES	-	Baa1	-
SEW	-	Baa2	BBB
SSC	-	Baa1	-

*Elsewhere in the business plan, Hafren Dyfrdwy state notional and actual target credit ratings of Baa1/BBB+ (Moody's/S&P) and South East Water state a notional target credit rating of Baa1/A- (Moody's/S&P)

** South West Water's licence provisions do not require the company to maintain a credit rating. However it is required to certify, in the opinion of the Board, it would be able to maintain an issuer credit rating which is an investment grade rating.

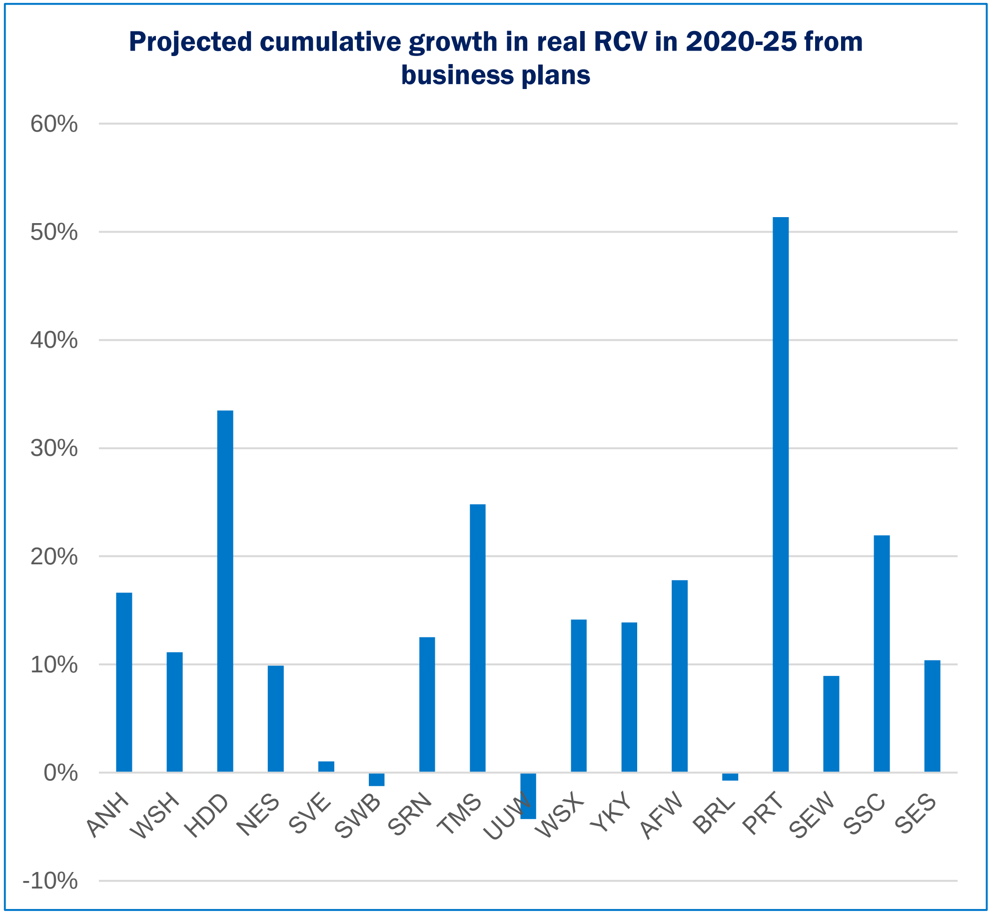
Source: business plan table App10

Notional dividend policy and RCV growth

In setting the proposed dividend yield, we expect each company to balance the investment needs and expected RCV growth with the needs of investors to make a reasonable return.

A company with high RCV growth may be expected to retain a higher proportion of its return to maintain reasonable gearing levels.

We do not expect the dividend yield to be higher than the real cost of capital on a blended CPIH:RPI.



Source: Business plan tables App 8

Water company	Dividend yield	Dividend growth	Retail dividend	Total
ANH	3.15%	1.35%	0%	4.50%
HDD	3.52%	1.51%	0%	5.03%
NES	5.00%	0%	0%	5.00%
SRN	3.57%	2.00%	0%	5.57%
SVE	3.52%	1.51%	0%	5.03%
SWB	4.00%	1.03%	0%	5.03%
TMS	5.00%	0.05%	0%	5.05%
WSH	2.60%	2.48%	0%	5.08%
WSX	Not provided			
UUW	5.04%	0%	0%	5.04%
YKY	4.47%[2]			
AFW	0.00%[2]			
BRL	3.20%	1.30%	0%	4.50%
PRT	5% of opening equity each year			
SES	3.42%[2]			
SEW	2.00%	Note 1	0%	Note 1
SSC	3.00%	2.03%	0%	5.03%

[1]South East Water has a range of dividend growth values across the five years from -42% to 103%.

[2]Calculated as a simple average of dividends divided by average regulatory equity for each year for companies with a dividend override in the submitted notional financial model that have hard coded the dividend assumptions for the notional structure. Average regulatory equity is calculated as 40% of average RCV. Affinity Water quote a dividend yield of 3.57% in its submitted notional financial model but the model overrides this to zero for each year.

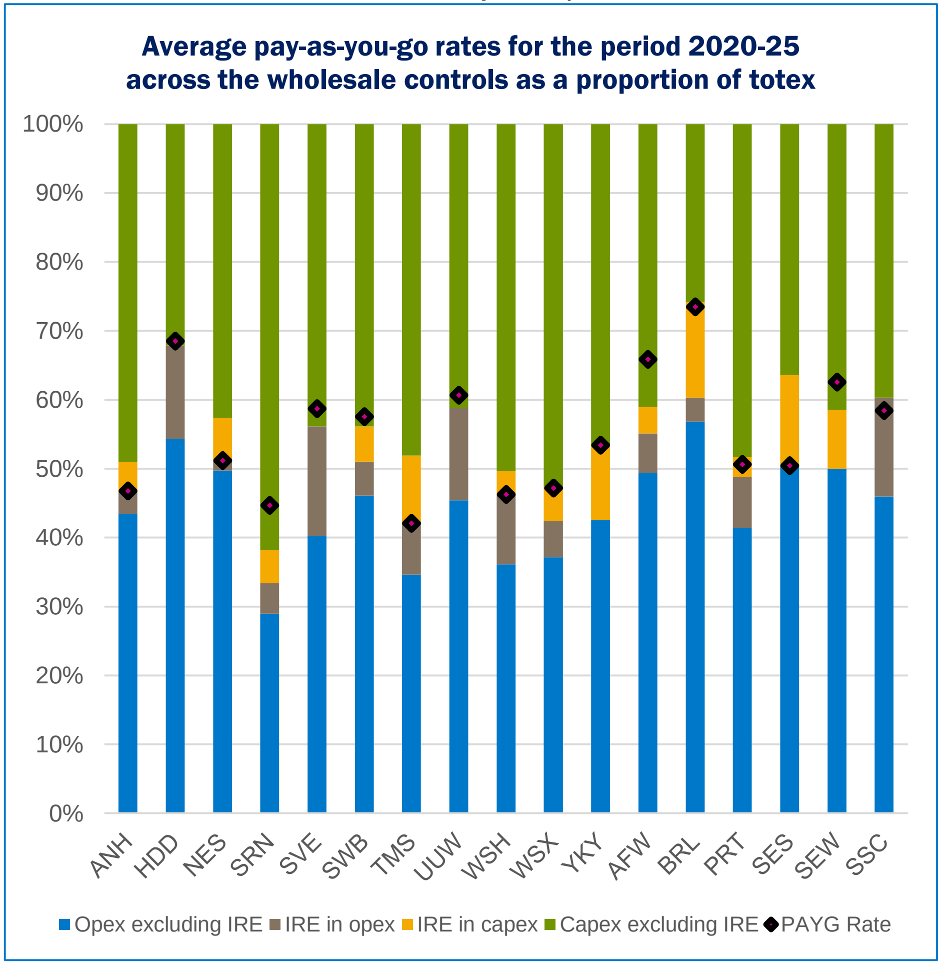
Source: Company business plans and financial models

Average pay-as-you-go and RCV run-off rates

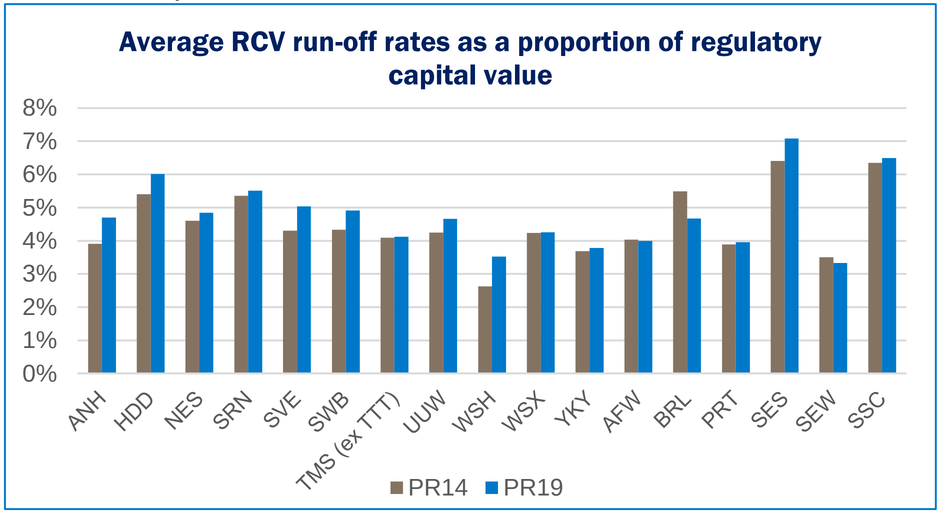
PAYG and RCV run-off rates balance the recovery of costs between current and future periods and have a significant impact on the level of customers' bills.

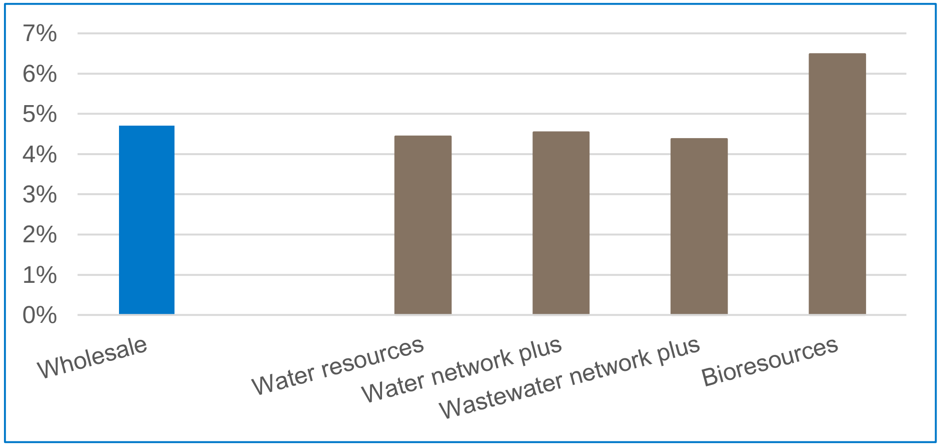
PAYG rates will vary according to the investment plans of each company. As such we compare PAYG rates to the level of operating costs and infrastructure renewal expenditure.

RCV run-off rates are more readily comparable across the sector and between periods.



Source: Business plan tables WS1, Wr4, Wn4, WWS1, WWn6, Bio5, Dmmy1, Dmmy 8. Calculated as weighted average PAYG rate as a proportion of total costs in 2017-18 prices across all wholesale controls





Source: Business plan tables WS1, Wr4, Wn4, WWS1, WWn6, Bio5, Dmmy1, Dmmy 8. Calculated as total run-off as a proportion of total regulatory capital values in 2017-18 prices across all wholesale controls as per business plan table App8