

April 2019

Trust in water

**PR19 draft determinations:
Severn Trent Water – Aligning risk
and return actions and interventions**

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Following our initial assessment of plans, we categorised two types of actions for fast-track companies:

- agreed actions that fast-track companies committed to implement to ensure that their plans meet the threshold for fast-track status; and
- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery).

Table 1 below sets out the agreed and required actions, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix 'SVE' denotes the company Severn Trent Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key of these acronyms. Actions whose numbers are preceded with an 'A' denote agreed or required actions.

Table 2 below sets out any further interventions that are not resulting from an action, which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix 'SVE' denotes the company Severn Trent Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key of these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Severn Trent Water draft determination, please see the [draft determinations webpage](#).

Table 1: Severn Trent Water's response to required actions and interventions for draft determinations

Test area	Action reference	Action type	Action	Date required	Summary of the company's response to the action	Our assessment and rationale	Interventions
Aligning risk and return	SVE.RR.A1	Required	The company has provided insufficient evidence to support the uncertainty mechanism requested for climate change. The company should remove the uncertainty mechanism for climate change or provide compelling evidence that the proposed bespoke uncertainty mechanism exposes the company to risks that are not adequately covered by the risk provisions already in place, and, for example could not be addressed	10am, 11th February 2019	Severn Trent Water has removed the uncertainty mechanism for climate change.	No intervention required. Severn Trent Water has complied with the action.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of the company's response to the action	Our assessment and rationale	Interventions
			through mechanisms such as transitional arrangements at PR24. If the company proposes to retain a bespoke mechanism for climate change, it should provide convincing evidence that the trigger mechanism adequately protects the interests of customers. Other uncertainties covered by the real options mechanism, are covered in the areas of cost assessment (WINEP and the interconnector) and as an outcome delivery incentive (metering).				
Aligning risk and return	SVE.RR.A2	Required	The financial model submitted for the notional company and used for the assessment of financeability includes a different interest rate and inflation assumption for index linked debt to that set out in the PR19 methodology for the notional company. The company should use the prescribed assumptions for the notional company including index linked debt in assessing the key financial ratios and financeability. The RPI rate of inflation should be used to translate the nominal cost of debt to real for index linked debt. The company should reconsider the need for the adjustment to RCV run-off rates as a result of the revised assessment of notional financeability.	10am, 11th February 2019	Severn Trent Water has revised the interest rate and inflation assumption for index linked debt as set out in the action and provided a new set of financial ratios in an updated financial model.	Severn Trent Water has complied with the action. However, following these adjustments, FFO/net debt is weak in relation to the notional financial structure.	We are intervening to increase RCV run off rates for the water network plus wholesale control of 0.2% in our draft determination to address a notional financeability constraint.

Test area	Action reference	Action type	Action	Date required	Summary of the company's response to the action	Our assessment and rationale	Interventions
Aligning risk and return	SVE.RR.A3	Required	We were not able to verify that the proposed RCV run-off rates are in line with the stated approach in the business plan and the company has proposed a 1.4% increase to RPI linked RCV run-off to achieve a claimed full transition to a CPIH basis. The CPIH:RPI wedge is inconsistent with the wedge set out in the early view cost of capital. The company should amend the RCV run-off adjustment to be consistent with our early view in the context of the 100bps wedge between RPI and CPIH referenced in Appendix 12 of our methodology.	10am, 11th February 2019	Severn Trent Water has amended the increase to RCV run off rates for RCV inflated by RPI. The revised adjustment is consistent with the 100bps CPIH:RPI wedge set out in the early view cost of capital.	No intervention required. Severn Trent Water has complied with the action.	N/A
Aligning risk and return	SVE.RR.A4	Required	The company should provide further evidence to support its adjustment to taxable profits included in APP29, with regards to the basis of the calculation and justification that the adjustment is appropriate and is in customers interest. We note from the commentary to the data tables that an adjustment has been made in respect of tax relief that you consider is not available for certain pension fund contributions. It is our understanding that where Asset Backed funding arrangements are used a deduction is normally available in respect of the contribution made by the employing company to the pension fund as part of the arrangements. Please confirm the timing and quantum of these contributions and whether tax relief has	10am, 11th February 2019	Severn Trent Water has provided further supporting evidence in relation to the calculation of tax.	Intervention required The adjustment proposed by the company to increase the level of taxable profits in the tax calculation relates to pension deficit repair contributions over and above the level funded by customers through price limits (as set out in IN13/17). As the pension feeder model will set the level of tax deduction available for pension contributions to the level set out in IN13/17, this adjustment is not required.	We are intervening to set the requested adjustment to zero.

Test area	Action reference	Action type	Action	Date required	Summary of the company's response to the action	Our assessment and rationale	Interventions
			been claimed in respect to each of the contributions and why this relief should not be taken into account when determining the tax liability to be funded at PR19. We need to be convinced that the adjustment is necessary and in the interest of customers if we are to make this bespoke adjustment to the financial model for the purpose of setting a draft determination.				

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
SVE.RR.C1	In our draft determination summary, we note that the RoRE risk ranges shown in Table 5.1 and Figure 5.1 reflect our interventions and, in particular, that we have included the RoRE risk ranges for ODIs shown in Table 2.3 of the summary document.	The company should provide an updated view of RoRE risk ranges at P10/P90 confidence levels in light of our draft determination. For this purpose, the company should apply its view on the interactions between individual ODI risks in arriving at an overall risk range for ODIs. Calculations should be carried out using the App26 rows on the F-Inputs tab of the draft determination financial model with values read off the model dashboard. The company's updated view should be provided in its response to the 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.

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