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Trust in water

PR19 draft determinations

Affinity Water – Aligning risk and return actions and interventions

Ofwat

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PR19 Draft Determinations: Affinity Water – Aligning risk and return actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised 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 'AFW' denotes the company Affinity Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Actions whose numbers are preceded with an 'A' denote required actions and actions whose numbers are preceded with a 'B' denote advised 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 'AFW' denotes the company Affinity Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Affinity Water draft determination, please see the **draft determinations webpage**.

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

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
Aligning risk and return	AFW.RR.A1	Required	The company should revise its business plan and associated financial modelling to be based on our 'early view' of long term CPIH of 2.0% and RPI of 3.0%, or provide compelling evidence why this is not appropriate.	1 April 2019	Affinity Water revised its business plan to use the long-term inflation assumptions of CPIH 2.0% and RPI 3.0%. This means that the WACC also aligns to our 'early view'.	No intervention required. We have reviewed Affinity Water's business plan and the company has provided sufficient evidence that it has adopted the long-term inflation assumptions from our 'early view' in the final methodology.	N/A
	AFW.RR.A2	Required	The company should provide further explanation to underpin the assumptions made on water trading in the RoRE analysis.	1 April 2019	Affinity Water says that it has revised its RoRE analysis for water trading and now considers small trades with neighbouring water companies and historical data on bulk supplies. It has also considered possibilities	No Intervention required. The company has responded satisfactorily to the action by considering possible cost and revenue impacts associated with	N/A

					for future additional water trading. Its revised RoRE risk range for water trading is - 0.12% to 0.17%.	current water trading arrangements and potential future opportunities. .	
	AFW.RR.A3	Required	The company should amend its overall assessment of RoRE outcomes, or provide convincing evidence to explain why it is reasonable to assume totex outcomes should be asymmetrically skewed to the downside for the notional company within an incentive based regime.	1 April 2019	Affinity Water says its totex downside skew related to bad debt risks and risks associated with customer data. It says the wholesale Totex RoRE outcome in its September plan was symmetrical and has remained symmetrical in its revised plan.	Intervention required. Affinity Water says that its P10 downside value for residential retail costs reflects bad debt risks and risks associated with customer data management, however, its downside risk range is double that of any other company and there is insufficient evidence to support this position.	We have adjusted the P10 value for Affinity Water's retail revenue risk to be more consistent with the higher downside scenarios proposed by other companies. The adjustment also reflects the inclusion of drivers addressing bad debt and its management in our cost assessment approach. The change applied amounts to a 50% reduction to the P10 retail cost risk value proposed by the company.
	AFW.RR.A4	Required	The company should remove the uncertainty mechanism for metaldehyde or provide further evidence to demonstrate why the uncertainty mechanism is required - specifically whether the cost item will remain uncertain at the time of draft and final determinations. The company should remove the uncertainty mechanism for sustainability reductions or provide convincing evidence that adequate protections are not already in place given totex cost sharing arrangements and scope for transitional arrangements at PR24. If the company retains an uncertainty mechanism in its revised business plan, it should ensure the proposal is underpinned by RoRE assessment in accordance with section 10.4.3 of the PR19 methodology.	1 April 2019	Affinity Water says that it has removed the uncertainty mechanism for metaldehyde from its plan in light of the announcement of a ban on metaldehyde sale and distribution from 30 June 2019 and on metaldehyde storage and use from 30 June 2020.	No intervention required. Affinity Water has removed the proposed uncertainty mechanism for metaldehyde.	N/A
	AFW.RR.A5	Required	The company should provide further evidence to reconcile the financial ratios set out in the business plan tables to those produced in the financial model and explain why these are appropriate for the company's assessment of financeability.	1 April 2019	The company has provided evidence that it has reconciled the company model with the Ofwat financial model. The company has provided evidence that the submitted model and data tables have received adequate	Intervention required. Affinity Water has completed the action. We are satisfied the resubmitted financial ratios within the revised business plan reconcile to the financial ratios produced by the Ofwat financial model.	Pursuant with action AFW.LR.A5, we expect the company to provide Board assurance to confirm it will maintain its financeability and long term resilience, taking account of the draft determination provisions. We further expect the company to provide additional third party assurance of any updates to the

					assurance from two separate third parties.	The company has provided evidence to support the appropriateness of the financial ratios based on its assessment of notional and actual financeability. The company has provided insufficient evidence to support the assessment of notional financeability. See action AFW.RR.A8 for further details of our assessment. The company has provided evidence of assurance from two separate third parties. We note that both external assurance providers identified issues with the process for completing the data tables, which although not material to our assessment of financeability, does raise some concerns over the internal assurance process.	business plan data tables that may occur following our draft determination, particularly to address the concerns raised by the third party assurance received as part of the April business plan submission.
	AFW.RR.A6	Required	The company should assess the financeability of the notional company in relation to financial ratios produced by the financial model for the notional company as set out in the methodology including the component parts of the early view cost of capital.	1 April 2019	The company has provided evidence to support the financeability of the notional company. The company has targeted a range of 1.5 to 2.5 for the adjusted interest cover ratio based on current guidance from Moody's and has considered 2.0+ an appropriate level. This target has been used to determine the level of PAYG adjustment required for notional financeability.	Intervention required. The target used for AICR is based on the overall Moody's guidance for Baa rather than recent guidance for the water sector. We consider that the level of the PAYG increase proposed to ensure notional financeability is not supported by convincing evidence that it represents an appropriate balance of cost recovery between current and future customers.	Affinity Water's initial approach for PAYG rates is to recover in each year an amount equivalent to operating costs and infrastructure renewals expenditure (IRE) within totex. We accept the company's initial approach and have intervened to align PAYG rates to reflect our view of the mix of operating and capital expenditure in our view of efficient totex. Affinity Water also proposes a 7.6% increase to PAYG to solve a financeability constraint for the notional company structure based on its target adjusted interest cover ratio for the notional company. We consider the scope of the increase is more than necessary and we intervene to reduce the increase to 1.3%, reducing allowed revenues by £86m. Affinity Water's RCV run-off rates are initially based on the depreciation rate for each wholesale control. We accept the company's approach. Affinity Water also proposes an

							increase to RCV run-off rates of 0.2% on average to balance bills across 2020-30. There is insufficient evidence that this adjustment is supported by customers and we are intervening to remove this adjustment, reducing allowed revenues by ~£17m.
	AFW.RR.A7	Required	The company should set out the steps taken and the assurance obtained by the board in order to assess financeability of the business plan.	1 April 2019	The company has provided a resubmitted Board assurance statement in relation to the reconciled financial model and financeability. The company has provided evidence that the submitted model and data tables have received adequate assurance from two separate third parties.	No intervention required. Affinity Water has provided a further Board assurance statement that the business plan is financeable on the basis of the notional and its actual company structure. In order to provide this assurance, the Board has considered the financial ratios and the ability of the company to maintain its credit ratings and meet its financial covenants. The Board has also considered the ability of the company to fund the business plan and reviewed the appropriateness and the results of the stress testing undertaken. Affinity Water has provided third party assurance that the financial model has been correctly populated and that the financial ratios provided in the data tables are consistent with the financial model. We note that both external assurance providers identified issues with the process for completing the data tables, which although not material to our assessment of financeability, does raise some concerns over the internal assurance process.	Pursuant with action AFW.LR.A5, we expect the company to provide Board assurance to confirm it will maintain its financeability and long term resilience, taking account of the draft determination provisions. As per action AFW.RR.A5, We further expect the company to provide additional third party assurance of any updates to the business plan data tables that may occur following our draft determination, particularly to address the concerns raised by the third party assurance received as part of the April business plan submission.
	AFW.RR.A8	Required	The company should provide further evidence to support its view that the key financial ratios are consistent with the target credit ratings including how the threshold levels for each of the ratios have been determined.	1 April 2019	The company has provided further evidence in relation to the key financial ratios for the notional structure and references the benefit of a one notch uplift for the actual structure due to its securitised structure.	Intervention required. Affinity Water has provided insufficient evidence in order to complete the action. Pursuant with action AFW.RR.A6, we are intervening to reduce the PAYG adjustment, proposed by the company to address a notional	Pursuant with action AFW.LR.A5, we expect the company to provide Board assurance to confirm how the financeability and financial resilience of the actual structure will be maintained in the context of our draft determination.

						financeability constraint. As the company has significant RCV growth, we consider investment should be partly provided by equity in a reduction in dividends applied (£71m). We remain concerned with the level of specific financial ratios for the actual company structure. We note that the business plan does not include the proposed reduction in gearing that Affinity Water sets out in its response to the initial assessment of plans, we note however that the company proposes to consider adjusting its capital structure once the outcome of the final determination is known. We are not intervening in respect of the financial ratios achieved under Affinity Water's actual financial structure in our draft determinations as it is Affinity Water that is responsible for ensuring it maintains financial resilience and the financeability of its activities over the long term. We note the level of the alternative adjusted interest cover ratio on the actual structure provides limited headroom against the target credit rating.	
	AFW.RR.A9	Required	The company should set out how the approach to setting PAYG and RCV run-off rates reflects the forecast costs and the depreciation of the underlying RCV for the company for each wholesale control and provide further evidence to demonstrate that the rates are consistent with the company's approach.	1 April 2019	The company has provided further evidence in relation to the calculation of the "natural" PAYG and RCV run-off rates.	Intervention required. Affinity Water has changed its approach to setting PAYG and RCV run off rates to reflect the forecast costs and depreciation of the underlying RCV and has provided sufficient evidence to support the underlying rates. The company has provided evidence that the 'natural' PAYG rates recovers operating costs and infrastructure renewals expenditure within totex. The company has provided evidence that the RCV run off rates are initially based on the depreciation rate for each wholesale control.	We are intervening in PAYG and RCV run-off rates. See intervention for action AFW.RR.A6.

						However, there is insufficient evidence that the increase in PAYG rates is required to maintain financeability for the notional capital structure. Affinity Water has applied a full year's depreciation to expenditure added to RCV in the year of addition. We do not consider this is an appropriate approach as this assumes all expenditure is incurred at the start of a financial year rather than evenly over the full 12 months of the financial year. We are intervening in the method of calculating RCV run off for post 2020 additions to RCV such that the RCV run-off rate is applied to 50 percent of new RCV in the year of addition which is consistent with the approach in the PR19 financial model.	
	AFW.RR.A10	Required	The company should set out the steps taken to address the concerns raised by the Customer Challenge Group in relation to the late addition of the final bill profile to the business plan, providing evidence that the annual bill profile set out in the business plan is consistent with customer preferences.	1 April 2019	The company has provided further evidence in relation to the action as well as the customer challenge group report in relation to the bill profile within the revised business plan.	Intervention required. Affinity Water states it is adjusting RCV run-off rates to smooth bills between 2020-25 and 2025-30 based on customer preferences for 'profile 2' in its acceptability testing. However, the evidence submitted suggests that both profile 1 and profile 2 show an increase of £4-£5 between 2024/25 and 2025/26 which is not consistent with the proposed bill profile in the revised business plan. We set out in response to action AFW.AV.A1 that we do not consider Affinity Water has not addressed our concern regarding the bill profiles tested with customers.	We are intervening in PAYG and RCV run-off rates. See intervention for action AFW.RR.A6

	AFW.RR.A11	Required	The company should provide convincing evidence that its exposure to revenue variation is as wide as its RoRE risk analysis suggests, particularly with regard to the regulatory protections in place.	1 April 2019	Affinity Water says that, having considered the impact of the revenue forecasting incentive, it has reduced its P10/P90 RoRE risk ranges for revenue to -0.01% and 0%.	No intervention required. Affinity Water has satisfactorily responded to the requirement, which takes account of the further guidance we provided in 'Technical Appendix 3: Aligning risk and return' of our initial assessment of business plans.	N/A
	AFW.RR.B1	Advised	The company should provide a clearer link between its internal risk management and mitigation procedures and the RoRE analysis.	1 April 2019	Affinity Water says it has aligned its RoRE risk range analysis with its internal strategic risks and the additional risk assumed in its revised business plan. The company says that mitigation has been factored into its assessment of RoRE risk ranges.	No intervention required. Affinity Water has responded adequately to this advised action.	N/A

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
AFW.RR.C1	Affinity Water's approach to setting PAYG rates is to recover operating expenditure including infrastructure renewal expenses included in operating costs. The application of efficient totex in our draft determination has resulted in a change to the mix of opex and capex in totex to the extent that PAYG rates are no longer aligned with Affinity Water's stated approach.	We are making a technical intervention to align PAYG rates to Affinity Water's stated approach of recovering operating expenditure for each year for each wholesale control.
AFW.RR.C2	Affinity Water says that its P10 downside value for residential retail costs reflects bad debt risks and risks associated with customer data management. Affinity Water's downside for residential retail cost risk is double that of any other company and there is insufficient evidence that the overall downside cost risk is appropriate. We have adjusted the P10 value to be more consistent with the higher end of downside scenarios proposed by other companies.	We are intervening to apply a 50% reduction to the retail cost risk proposed by the company to reduce the downward skew in its level of residential retail costs risk.
AFW.RR.C3	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. This approach seeks to take account of covariance in performance on individual outcome delivery incentives.	We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework.
AFW.RR.C4	We expect companies to update their RoRE risk range analysis in response to the draft determinations.	We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the 'Aligning risk and return technical appendix' that accompanies our draft determination and 'Technical appendix 3: aligning risk and return' published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the company, taking account of the company's reported level of actual performance delivered in

		2015-19 and taking account of the steps it is already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk.”

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.

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.gov.uk

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