

July 2019

Trust in water

PR19 draft determinations

**Bristol Water – Aligning risk and return actions
and interventions**

PR19 Draft Determinations: Bristol 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 'BRL' denotes the company Bristol 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 'BRL' denotes the company Bristol 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 Bristol Water draft determination, please see the [draft determinations webpage](#).

Table 1: Bristol 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 | BRL.RR.A1 | Required | The company should remove the requested company specific adjustment from its plan and associated financial modelling or provide compelling evidence following the three-stage approach set out in the PR19 methodology if it continues to request a company specific adjustment. | 1 April 2019 | <p>Bristol Water has retained the assumption of a company-specific adjustment to its cost of capital in its resubmitted plan, providing more evidence to support its view that it passes the three-stage assessment approach set out in the PR19 final methodology.</p> <p>The level of adjustment on the cost of embedded debt remains the same (55bp) but the company has removed its uplift formerly applying to new debt (15bp). At our old ratio of new: embedded debt, this would have reduced from 45bps to 38bps. However, at our new</p> | <p>Intervention required.</p> <p>Overall we consider the company has passed our Customer Support Assessment, but not our Levels or Benefits assessments – failing the criteria overall for receiving a company-specific adjustment.</p> <p>Regarding our levels assessment, the reduction in the company-specific adjustment still results in an overall uplift above our plausible range of 25-40bps.</p> | We are intervening to apply our view of the sector cost of capital to the company's allowed revenues for draft determinations. |

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| | | | | | <p>ratio, its uplift is 44bps.</p> <p>Bristol Water critiques our approach to assessing benefits and proposes more sources of benefit. Overall it gives a range of potential benefits from -£11.3 million to £158.6 million, with a central estimate of £20.7 million.</p> <p>Bristol Water surveyed 451 customers to test support for its proposed uplift, finding 87% were very or fairly content to fund it.</p> | <p>In addition, we did not find the evidence used to derive the company's 55bp embedded debt uplift to be convincing, as it was derived using a limited set of debt instruments, and compared spreads for the three Artesian financing vehicles, rather than the more granular tranches of borrowing.</p> <p>On our benefits assessment, Bristol Water made several arguments that our approach to estimating benefits was flawed, and proposed additional approaches and sources of benefit. After revising our model to reflect these challenges, and the impact of new data, and reviewing Bristol's arguments, we consider that there remains no compelling evidence that customers will receive benefits that adequately compensate them for the cost of the uplift.</p> <p>On Customer Support, we accept that Bristol Water's resubmitted evidence is adequate to demonstrate that customers support funding its proposed uplift, with a significant majority of surveyed customers unconditionally supporting funding the cost on their bills.</p> | |
| BRL.RR.A2 | Required | The company should provide further information on its proposed uncertainty mechanism relating to Canal & River Trust costs – to consider specifically whether the cost item will remain uncertain at the time of draft and final determinations. | 1 April 2019 | Bristol Water has confirmed that it cannot reach agreement with Canal & River Trust (CRT) on CRT's proposed increase in charges for water abstraction from the Gloucester and Sharpness Canal and the matter has now moved to arbitration. Consequently the position may remain uncertain at the time of our final determination. | <p>Intervention required.</p> <p>Bristol Water's PR19 business plan included a proposal for a Notified Item in respect of possible changes to its costs for abstracting water from the Gloucester and Sharpness Canal. We have considered the supporting evidence and RoRE analysis provided by the company and propose a two-way Notified Item under</p> | We have included a notified item in Bristol Water's draft determination that would allow for an interim price determination. The company should provide its views on this, and the associated proposals we set out in the PR19 | |

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| | | | | | <p>Bristol Water has not included a potential increase in cost rates in its business plan cost submission. The company has proposed a mechanism under which, subject to the materiality test set out in Condition B of its licence, customers would bear 75% of any increase in costs instead of the 50% that would be borne under the standard totex cost sharing mechanism. It has also proposed that the mechanism should be symmetrical with customers retaining 75% of the savings if costs are reduced instead of increased.</p> | <p>the provisions of Condition B of Bristol Water's licence. Bristol Water's draft determination includes an allowance for water resource costs. However, the company has set out that it might be exposed to increased charge rates as a result of a review that has been instigated by Canal & River Trust (CRT) under the terms of the supply agreement between the two parties. It is also possible that there could be a decrease in costs as a result of the review. The outcome of the review is presently uncertain, and has been referred to arbitration. A Notified Item means that Bristol Water would be able to ask for an interim determination of its allowed revenue in the 2020-2025 period if the associated costs pass the defined materiality threshold.</p> <p>We have included a Notified Item in Bristol Water's draft determination because:</p> <ul style="list-style-type: none"> • The costs position is currently uncertain and may be unresolved before our final determination because it depends on the outcome of a formal review. In that respect, the costs are beyond Bristol Water's management control. • Bristol Water has explained that the supply of water from the Gloucester and Sharpness Canal represents a significant (45%) proportion of its water resources and that alternative supply possibilities would be very expensive. • The potential additional costs of up to £8m per year (if the full charge | <p>draft determination: Aligning risk and return technical appendix and our summary of Bristol Water's draft determination. In particular we ask Bristol Water to:</p> <ul style="list-style-type: none"> • reflect any changes to charge levels for abstracting water from the Gloucester and Sharpness Canal (whether an increase or a decrease) and reflect the change in its annual performance reporting; and • In the event of an interim determination that increases baseline allowances, to collect only 75% of the increased amount in accordance with its proposal. We propose this to be achieved through adjustments to targeted revenue in the RFI for Bristol Water. |
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| | | | | | | <p>increases sought by CRT are allowed) represent a material financial risk for Bristol Water, with potential impacts on its financeability.</p> <ul style="list-style-type: none"> Bristol Water has proposed a symmetrical Notified Item under which customers would effectively bear only 75% of any increase in costs in the event that the interim determination is triggered. Customers could benefit if costs go down as a result of the review. This approach protects the interests of customers. <p>We conclude that the bespoke uncertainty mechanism proposed by Bristol Water balances the interests of customers and the company in this instance given the uncertainty associated with costs of its future abstraction charge. However, we have amended the drafting of the Notified Item provided by the company and set out associated information in the PR19 draft determination: Aligning risk and return technical appendix and in the company summary document for Bristol Water.</p> | |
| BRL.RR.A3 | Required | The company has targeted a credit rating for the notional company that is one notch above the minimum investment grade rating. The company should provide convincing evidence to support its view that this is reasonable for the long term financeability of the notional company or actions that could be taken to secure the long term financeability of the notional company. | 1 April 2019 | <p>Following a query relating to inconsistencies in relation to the target credit rating for the notional company, Bristol Water has confirmed that the target for the notional company is two notches above minimum investment grade ratings.</p> <p>The company states that it considers a notionally geared and financed Bristol Water would be expected to be in line with a strong Baa2 based on current rating agency sentiment, but in the long run be Baa1. Bristol Water considers the current sentiment on</p> | <p>No intervention required.</p> <p>Following a query to clarify the target credit rating for the notional company, Bristol Water has completed the action.</p> <p>On the basis of the notional company, we consider the draft determination would allow the company to achieve a credit rating two notches above the minimum investment grade.</p> | N/A | |

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| | | | | | the regulatory framework to be a short term perspective. | | |
| | BRL.RR.A4 | Required | The company has targeted a credit rating for its actual structure that is one notch above the minimum investment grade rating, and lower than its current credit rating. The company should provide further evidence, and Board assurance, to support its view that this is reasonable for the financeability of the actual company. | 1 April 2019 | <p>Bristol Water has provided further Board assurance and evidence to support a target credit rating for the actual company of one notch above a minimum investment grade rating.</p> <p>The company refers to successful refinancing as providing confidence of its financeability at efficient and competitive pricing levels. Bristol Water also refers to the long dated existing debt and relatively low refinancing requirement as support that it is targeting an appropriate credit rating. It considers that the company will be in a strong and financeable position to raise the low level of debt required (c£9m) in the forthcoming period at a Baa2 rating from Moody's.</p> <p>The company provides a third party report, as to why the Baa2 actual rating is appropriate for the company given its circumstances. The company proposes that either a strong Baa2 or Baa1 is appropriate and reasonable to obtain efficient financing for the short and long term.</p> | <p>No intervention but action required.</p> <p>The company has only a limited debt financing requirement in 2020-25; this together with the Board assurance statement provides some comfort that the plan is financeable.</p> <p>However, consistent with action BRL.LR.A4 on financial resilience, there is limited headroom in the projected financial ratios and we require further Board assurance of the actions the company will take to maintain its financial resilience in the context of the draft determination, which includes, for example, an updated view of the cost of capital, our assessment of efficient costs and our assessment of outcome delivery incentives.</p> | Pursuant to action BRL.LR.A4, we require the company to provide additional Board assurance that the company will remain financeable in 2020-25 in the context of our draft determination. |
| | BRL.RR.A5 | Required | Further evidence and Board assurance is required that the business plan is consistent with maintaining the target credit rating given the weak financial ratios set out in the plan. | 1 April 2019 | <p>Bristol Water sets out that, whilst the adjusted interest cover ratio is weaker than historically, it is one of a number of factors considered by the credit rating agencies, and needs to be taken in this wider context. The company also sets out that throughout the period, it assesses that the S&P BBB rating remains strong, based on ratios and wider factors throughout the period and further supports the targeted rating level. The financial headroom is thus considered to be appropriate as BRL.RR.A4 suggests.</p> | <p>No intervention but action required.</p> <p>Bristol Water has provided further evidence including a third party report to support its Board assurance that the business plan is financeable under the actual company structure.</p> <p>Bristol Water acknowledges certain financial ratios presented are weak for the actual company. However, the company has a low amount of debt to issue over 2020-25 to</p> | Pursuant to action BRL.LR.A4, we require the company to provide additional Board assurance that the company will remain financeable in 2020-25 in the context of our draft determination. |

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| | | | | | <p>The Board assurance statement includes specific reference to their support for the business plan and the financial ratios proposed. The company sets out that detailed discussions have been held with the Board with regard to the financial modelling, credit ratios and resultant financeability and financial resilience. This has been specifically discussed and debated with the Board throughout the submission process.</p> | <p>fund the draft determination. We are not intervening in Bristol Water's determination in respect of the financial ratios of its actual structure.</p> | |
| | BRL.RR.A6 | Required | <p>The company should ensure it is using the correct assumptions, including the cost of debt without a company specific adjustment, for the notional company in assessing the key financial ratios.</p> | 1 April 2019 | <p>Bristol Water states it has assessed the financial ratios with and without the requested company specific adjustment to the cost of debt, although based on the evidence it presents, it considers the central position for financial resilience testing is a notional company with the cost of capital adjustment requested.</p> <p>The company shows in business plan table App10 the notional ratios without the company specific adjustment, although it includes prior period reconciliation adjustments.</p> | <p>No intervention required.</p> <p>Bristol Water has completed the action; financial ratios both with and without the company specific adjustment are presented in the plan.</p> | N/A |
| | BRL.RR.A7 | Required | <p>The company should provide further evidence to support the calculation of RCV run-off rates and demonstrate that the rates are consistent with the approach set out in the business plan.</p> | 1 April 2019 | <p>The company has provided the details of the calculation of the natural rates for the water resources and network plus controls with a breakdown of the capital expenditure, depreciation, net book values and grants and contributions. The company has also provided details of the adjustments proposed to the natural rate to account for the transition from RPI to CPIH.</p> | <p>No intervention required.</p> <p>Bristol Water has completed the action.</p> <p>Bristol Water has provided sufficient evidence in support of the proposed RCV run off rates. The company has provided the details of the calculation of the natural rates for each control with a breakdown of the capital expenditure, depreciation, net book value and grants and contributions. The company has also provided the details of any adjustments to the natural rate to account for the transition from RPI to CPIH.</p> | N/A |

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| | BRL.RR.A8 | Required | There are inconsistencies in the stated WACC inputs between main business plan document, business plan tables and submitted financial model. The company should ensure its subsequent submission contains a consistent set of assumptions. | 1 April 2019 | Bristol Water advised that this has been corrected in the revised plan by not rounding the data tables to the stated two decimal places. | No intervention is required. We reviewed Bristol Water's updated business tables and financial model and we can confirm the company has provided sufficient evidence that the business tables and financial model are now consistent. | N/A |
| | Advised actions | Advised | No advised actions | N/A | | | |

Table 2: Further interventions for draft determinations

| Intervention reference | Our assessment and rationale | Interventions |
|------------------------|--|--|
| BRL.RR.C1 | Bristol 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 Bristol Water's stated approach. | We are making a technical intervention to align PAYG rates to Bristol Water's stated approach of recovering operating expenditure for each year for each wholesale control. |
| BRL.RR.C2 | 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. |
| BRL.RR.C3 | 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.

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