

July 2019

Trust in water

# PR19 draft determinations

**Dŵr Cymru – Aligning risk and return actions  
and interventions**

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## PR19 Draft Determinations: Dŵr Cymru – 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 'WSH' denotes the company Dŵr Cymru. 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 'WSH' denotes the company Dŵr Cymru. 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 Dŵr Cymru draft determination, please see the [draft determinations webpage](#).

**Table 1: Dŵr Cymru'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	WSH.RR.A1	Required	The company should remove the uncertainty mechanism for business rates or provide compelling evidence to support the proposed uncertainty mechanism to support its view that adequate protections are not already in place given totex cost sharing arrangements. 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	Dŵr Cymru has removed the uncertainty mechanism for business rates from its plan.	No Intervention required.	N/A
	WSH.RR.A2	Required	The company should provide further evidence on whether it is reasonable to assume totex outcomes (in RoRE risk analysis) should be asymmetrically skewed to the downside or provide compelling evidence that this is an appropriate assumption within an incentive based regime.	1 April 2019	Dŵr Cymru remains of the view that the distribution of totex outcome risks is skewed to the downside. It considers this relates to the level of allowed costs for PR19 price determination.	No intervention but action required. Our view is that an efficient company should be able to achieve the base equity return on the notional structure.	Dŵr Cymru should consider necessary revisions to its overall RoRE range in response to the draft determination.

WSH.RR.A3	Required	<p>The company has targeted a credit rating for the notional company that is one notch above the minimum for investment grade and lower than the target for its actual structure. The company should provide 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.</p>	1 April 2019	<p>The company states it has amended the target credit rating for the notional company to Baa1/BBB+/BBB+ (Moody's S&amp;P and Fitch respectively). It believes this to be a suitable target for a notional company which is financially resilient for the longer term.</p> <p>The company notes that against a Baa1/BBB+/BBB+ target credit rating, notional company financeability is very tight.</p> <p>The company refers to Anglian Water's "PR19 – Notional Company Financeability" publication which explores the relationship between the allowed cost of equity and notional financeability. The company states as Ofwat considers its final WACC, it is vital that Ofwat considers whether headroom is needed above the minimum required notional ratios for Baa1/BBB+/BBB+ credit ratings.</p>	<p>No intervention required.</p> <p>The company has amended its target credit rating for the notional company structure to provide two notches of headroom to the minimum investment grade based on a review of other company's business plans. A credit rating two notches above the minimum investment grade provides additional resilience for the company to withstand cost shocks.</p>	N/A.
WSH.RR.A4	Required	<p>The company should provide further evidence that the business plan is consistent with the target credit rating on its actual corporate structure, in particular setting out threshold levels for key financial ratios and how these are consistent with the target credit ratings.</p>	1 April 2019	<p>The company has provided further evidence setting out the thresholds level for key financial ratios and how these are consistent with the target credit rating for the actual company.</p>	<p>Intervention required.</p> <p>Dŵr Cymru has set out the thresholds for certain financial ratios that have been used to assess actual company financeability. However, the financial ratios for adjusted interest cover and for FFO/Net debt set out in the revised business plan tables, including the company specific additional financial ratios, do not achieve these thresholds.</p> <p>The company sets out that the covenanted debt structure provides a one notch uplift to the credit rating and that the credit metrics are consistent</p>	<p>We expect Dŵr Cymru to provide further evidence to support the basis of its actual financeability assessment and additional Board assurance that the company is financially resilient as set out in action WSH.LR.C1.</p>

						<p>with a BBB+/Baa1/BBB+ credit rating, but it is unclear how this relates to the target thresholds set out in the response.</p> <p>The company has also stated that it has assessed actual financeability excluding post financeability adjustments. Whilst this is appropriate for the notional company to avoid diminishing the incentive regime, it does not reflect the reality faced by the company. However, Dŵr Cymru has set out this is not material.</p>	
	WSH.RR.A5	Required	The company should ensure it is using the correct assumptions for the notional company in assessing the key financial ratios. The RPI rate of inflation should be used to translate the nominal cost of debt to real for index linked debt.	1 April 2019	The company has changed the assumption for the real cost of index linked debt from 2.32% to 1.32%. It has now adjusted the nominal cost of debt using the RPI rate of inflation.	<p>No intervention required.</p> <p>Dŵr Cymru has completed the action.</p>	N/A
	WSH.RR.A6	Required	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.	1 April 2019	<p>The company has provided a third party report as evidence to support the calculation of the RCV run off rates and to demonstrate that the rates are based on the engineering lives of the underlying assets which are then weighted using the gross MEAV.</p> <p>Dwr Cymru has provided additional evidence to support the methodology for calculating RCV run-off rates based on estimated average asset lives determined using a MEAV tool. We accept this is an appropriate means of determining RCV run off rates.</p>	<p>No intervention required.</p> <p>Dŵr Cymru's RCV run off rates are based on a range of estimates of average asset lives for assets within each wholesale control. The range of estimates is wide and the company provides little evidence to support the final rates chosen. However the company RCV run off rates are lower than the sector average and we accept Dŵr Cymru's RCV run off rates for the draft determination</p>	N/A
	Advised actions	Advised	No advised actions.	N/A			

**Table 2: Further interventions for draft determinations**

Intervention reference	Our assessment and rationale	Interventions
WSH.RR.C1	<p>Dŵr Cymru's approach to setting PAYG rates is to recover operating expenditure. 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 Dŵr Cymru's stated approach.</p> <p>Dŵr Cymru has not updated its PAYG rates to reflect the changes it has made to operating and capital expenditure within totex in its revised business plan. Therefore, the PAYG rates are not consistent with the company's stated methodology.</p>	<p>We are making a technical intervention to align PAYG rates to Dŵr Cymru's stated approach of recovering operating expenditure for each year for each wholesale control.</p>
WSH.RR.C2	<p>Dŵr Cymru has not included any downside RoRE range for D-Mex &amp; C-Mex in its assessment of financial risk factors for 2020-25.</p>	<p>The company should explain why it considers it appropriate to assess no downside risk range for D-Mex &amp; C-Mex in its financial risk analysis, referring, where appropriate, to its historical performance under the SIM mechanism and in the C-Mex pilot study.</p>
WSH.RR.C3	<p>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.</p>	<p>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.</p>
WSH.RR.C4	<p>We expect companies to update their RoRE risk range analysis in response to the draft determinations.</p>	<p>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.</p>

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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