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Trust in water

PR19 draft determinations

Hafren Dyfrdwy – Aligning risk and return actions and interventions

Ofwat

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PR19 Draft Determinations: Hafren Dyfrdwy – 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 'HDD' denotes the company Hafren Dyfrdwy. 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 'HDD' denotes the company Hafren Dyfrdwy. 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 Hafren Dyfrdwy draft determination, please see the **draft determinations webpage**.

Table 1: Hafren Dyfrdwy'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	HDD.RR.A1	Required	The company proposes a net margin of 1.20% for<5ML/yr users despite operating in a non-contested market segment. The company should limit its margin to the PR16 1.0% cap, or provide compelling evidence why this is not appropriate.	1 April 2019	Hafren Dyfrdwy has provided further evidence to demonstrate that the overall margin for customers in the non-contested segment is only 1% as per PR16.	No intervention required. Hafren Dyfrdwy has provided sufficient further narrative that the net margin cap is below 1.0% overall, and this is consistent with PR16.	N/A
	HDD.RR.A2	Required	The company should amend its assessment of revenue variance in its RoRE risk analysis or provide convincing evidence that its exposure to revenue variation is as wide as its analysis suggests, particularly given the PR19 methodology.	1 April 2019	Hafren Dyfrdwy says that as a small company it expects its revenue to be more volatile than a large company, with large industrial customers being particularly important for the business. It notes that connection charges, which are significant for the company, are outside the scope of the revenue forecasting incentive (RFI).	No intervention required. Whilst Hafren Dyfrdwy's downside RoRE risk range for revenue remains relatively large in comparison with other companies, the company provides sufficient justification for its view.	N/A

					Hafren Dyfrdwy considers that the majority of revenue impact occurs in the non-household retail control and bio-resources, where a loss of customers or volumes can lead to variances that are not corrected. In response to the required action, however, the company has reconsidered the effect of the RFI and now considers its RoRE risk range for revenue to be from -0.42% on the downside to 0.24% on the upside. Hafren Dyfrdwy does not expect one-off data cleansing impacts following the business's border variation will be repeated.		
	HDD.RR.A3	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 evidence to explain the steps taken and the assurance obtained by the Board to assess financeability. The company has submitted evidence to show the process for assuring the Board the plan is financeable and financially resilient. The plan details a four step approach for assessing financial resilience, a review of the modelling outputs and any mitigating actions that have arisen during the review.	No intervention required Hafren Dyfrdwy has completed the action. The company has clearly set out the steps taken by the Board in providing its assurance statement on financeability.	N/A
	HDD.RR.A4	Required	The company should provide clarity with appropriate reasoning for the credit ratings targeted for both the notional and its actual company structure and should set out further evidence that the key financial ratios are consistent with the target credit ratings including threshold levels for the ratios.	1 April 2019	The company has provided evidence to explain the target credit ratings for actual and notional structure. It has set out the financial ratios and thresholds and how these are consistent with the target credit ratings for both the notional and actual structures.	No intervention required. Hafren Dyfrdwy has completed the action. The company sets out it has used its own model to assess financeability which it has reconciled to the Ofwat model, showing where differences occur and providing a full suite of financial ratios that support the target credit rating.	N/A
	HDD.RR.A5	Required	The company should ensure it is using the correct assumptions for the notional company including the cost of debt 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 adjusted the inputs to ensure that the nominal cost of debt has been deflated with RPI to provide a real rate for index linked debt.	No intervention required. Hafren Dyfrdwy has completed the action. The company has amended its assumptions to be consistent with our expectations.	N/A

	HDD.RR.A6	Required	The company should provide further evidence to support the calculation of PAYG and RCV run-off rates and demonstrate that the starting point for the rates are consistent with the approach set out in the business plan.	1 April 2019	The company provides evidence to explain the basis for the starting points for both PAYG and RCV run off rates as well as evidence to support the adjustments made.	Intervention required. Hafren Dyfrdwy has provided further evidence to support the calculation of PAYG and RCV run off rates. There is convincing evidence that PAYG rates are appropriate. The company has set out sufficient evidence to support applying a backward-looking approach to RCV run-off rates based on the amount customers were funding at PR14. This looks at historical rates for assets that were transferred to the company at the time of the border variation due to the mismatch between the value of the assets and the RCV transferred at that time. The company applies a reduction to RCV run-off rates to maintain affordability and the commitments made regarding bills at the time of the border variation. However, there is insufficient evidence to support the increase in RCV run off rates for the wastewater network plus control from those in the original business plan in September 2018.	We are intervening in RCV run off rates for the wastewater network plus control to reduce rates to the level proposed in the original business plan.
	HDD.RR.A7	Required	The company should provide further evidence that the proposed adjustments to PAYG and RCV run-off rates achieve the objectives set out in the business plan and are consistent with the commitments set out in the NAV application.	1 April 2019	The company provides evidence to explain the basis for the starting points for both PAYG and RCV run-off rates as well as evidence to support the adjustments made. The company set outs the NAV commitments in detail and how these have been met.	Intervention required. Hafren Dyfrdwy's RCV run-off rates are initially based on the depreciation rate for each wholesale control. However, to maintain affordability and the commitments made at the time of the border variation (NAV), the company has reduced RCV run off rates. We accept the final rates for all wholesale controls except for the wastewater network plus control which has	As per action HDD.RR.A6

						increased from the original submission. Hafren Dyfrdwy has not provided sufficient evidence for the increase.	
	HDD.RR.A8	Required	The company should set out the steps taken to address the concerns raised by the Customer Challenge Group and CCWater in relation to the final bill profile for water customers, providing further evidence that the final bill profile set out in the business plan is consistent with customer preferences for all customers or revise the bill increase for water only customers in line the profile presented to customers.	1 April 2019	The company has provided further evidence that it tested a 2.5% bill increase in Powys (original plan: Acceptability wave 2) and a 3.6% bill increase in Wrexham (new project: Acceptability wave 3). In the revised submission the actual change in the combined bill is lower than in the original submission, at 1.9%, due to a change in the AMP6 closing position. This means in both regions the actual change in bill is lower than that tested.	No intervention required. Hafren Dyfrdwy provides evidence of profiles representing various PAYG and RCV run-off rates, modelling the NAV commitments, smoothing bills and balancing bills between services and presented two profile to customers including the bill profile proposed in the revised business plan. The company has provided further evidence of customer support for the increase it is proposing for water only customers. Combined with the testing for water and wastewater customers, the evidence summarises the level of support for the bill increase for all customers, although we note in in our response to action HDD.AV.A1 set out in 'Hafren Dyfrdwy Addressing affordability and vulnerability actions and interventions' that bill acceptability is not high. We note our interventions to Hafren Dyfrdwy results in a lower bill, with a 2.4% reduction in draft determination, and so do not require further evidence of acceptability from Hafren Dyfrdwy The customer challenge group provided a report on the revised business plan and were satisfied the research approach was carried out in accordance with best practice.	N/A

	HDD.RR.B1	Advised	The company should explain in further detail how its risk management and risk mitigation measures are taken into account in its RoRE assessment	1 April 2019	Hafren Dyfrdwy has set out further detail on its rationale for assessing the RoRE risk assessment categories and the mitigating actions available to the company. It says that, in addition to the revenue forecasting incentive, these include: • possible cost savings to offset revenue losses if a large customer is lost; • deferral or rescheduling of investment; and • improved capital management.	No intervention required. The company has responded satisfactorily to the advised action.	N/A

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
HDD.RR.C1	Hafren Dyfrdwy's approach to setting PAYG rates is to recover operating expenditure and infrastructure renewal expenses. 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 Hafren Dyfrdwy's stated approach.	We are making a technical intervention to align PAYG rates to Hafren Dyfrdwy's stated approach of recovering operating expenditure for each year for each wholesale control.
HDD.RR.C2	Hafren Dyfrdwy expects to generate tax losses over the period 2020-25, which will be surrendered to the group, with payment received at full value. Our PR19 methodology allows us to capture the full value of the tax losses surrendered and deduct them from the tax allowance. This ensures that customers do not lose out as a result of losses being transferred out of the company that could otherwise be offset against tax liabilities in the future.	We are intervening to adjust the revenue requirement (post financeability) in the draft determination for the company to reflect the payment received from the group for tax losses surrendered. This will ensure customers benefit from the tax losses in the period they are generated.
HDD.RR.C3	We are intervening to reduce the quantum of Hafren Dyfrdwy's downside Totex risk by £5 million. Whilst Hafren Dyfrdwy refers to challenging efficiency assumptions for the wholesale price controls in its plan, the base cost allowance totals we have determined (set out in section 3.2) are higher than the company's view.	We are intervening to reduce the level of Wholesale totex by £5 million over the period 2020-25.
HDD.RR.C4	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.
HDD.RR.C5	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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