

July 2019

Trust in water

# PR19 draft determinations

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

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

**Table 1: Northumbrian 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 | NES.RR.A1        | Required    | The company should amend its assessment of revenue variance in its RoRE 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  | Northumbrian Water says that the RoRE risk range for revenue in its business plan resubmission takes the effect of the revenue forecasting incentive (RFI) into account. The company has retained its original analysis of single year variance, but now assumes that subsequent years have zero variations. This brings its RoRE risk range for revenue down from +/-0.7% to +/- 0.3%. | No intervention required.<br>The company has completed the action. | N/A                    |
|                          | NES.RR.A2        | Required    | The company should explain in more detail the assumptions underpinning the low water trading RoRE scenario or amend the scenario.  | 1 April 2019  | Northumbrian Water says it had included the impact of losing an existing major contract in the P10 downside value for water trading in its original submission. On review it now considers this risk to be outside the P10 range and has removed the impact from its RoRE risk range.   | No intervention required.<br>The company has completed the action. | N/A                    |

| Test area | Action reference | Action type | Action  | Date required | Summary of company response to action  | Our assessment and rationale   | Required interventions |
|-----------|------------------|-------------|---|---------------|--|--|------------------------|
|           | NES.RR.A3        | Required    | There is inconsistency between the notional cost of equity in financial model and the data tables. The company should ensure its subsequent submission is consistent in this respect. | 1 April 2019  | Northumbrian Water has amended its tables to arrive to a wholesale cost of capital of exactly 5.37%. | No intervention required.<br><br>We reviewed Northumbrian Water's updated business plan and the company has provided sufficient evidence that the cost of equity in the financial model and business table are now consistent. | N/A                    |
|           | Advised actions  | Advised     | No required actions.  | N/A           |  |  |                        |

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

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