July 2019

Trust in water

PR19 draft determinations

Portsmouth Water – Aligning risk and return actions and interventions

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PR19 Draft Determinations: Portsmouth 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 'PRT' denotes the company Portsmouth 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 'PRT' denotes the company Portsmouth 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 Portsmouth Water draft determination, please see the **draft determinations webpage**.

Table 1: Portsmouth 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	PRT.RR.A1	Required	The company has proposed a target credit rating for the notional company that is three notches above a minimum investment grade and two notches higher than the target credit rating for the actual company. The company should provide further evidence to support its view that this is a reasonable balance between maintaining the financeability of the notional company and securing affordable bills for customers.	1 April 2019	Portsmouth Water confirms the Board has concluded that the Company is financeable for the notional capital structure and has achieved an appropriate balance between financeability and customer bill levels. The Board considers this conclusion is further supported by analysis to consider financial shocks and downsides and the Company's ability to raise debt in the notional structure. The Board has revised its target for the notional structure from A3 to Baa1.	No intervention required. Portsmouth Water has provided sufficient evidence to support the rationale for the revised target credit rating in relation to adequate financial resilience, use of PAYG levers, balance between financeability and bill levels and the ability to raise debt. The company has provided sufficient evidence in response to the action. However, to note we assess the level of PAYG adjustment and the level of the key financial ratios in supporting	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
						the target credit rating as discussed in PRT.RR.A3. To note, our initial assessment of financeability excludes Havant Thicket to reflect the separate price control. We then consider the ratios including Havant Thicket noting the impact of the high costs and long term nature of the control on the funds from operations/debt ratio.	
	PRT.RR.A2	Required	The company has proposed a target credit rating for the actual company that is one notch above a minimum investment grade and two notches lower than the target credit rating for the notional company. The company should provide further evidence to support its view that this is reasonable for the financeability of the company given the proposed investment and the funding requirement of the company.	1 April 2019	The company considers a target credit rating of Baa2/BBB appropriate for the actual target credit rating due to downward pressure influenced by the lower allowed return (WACC), the company's embedded debt and the absence of effective mitigation actions. The company states the Board has accepted that a downgrade to Baa2/BBB is likely in the actual structure if the company cannot demonstrate higher levels of returns.	No intervention but further action required. Portsmouth Water has provided sufficient evidence to support the rationale for the revised target credit rating. We note, actual financeability is impacted by the lower cost of capital and the lower cost of debt associated with the separate price control for Havant Thicket.	Pursuant to action PRT.LR.A5, the company should provide further assurance about how it will maintain its long term financial resilience and, in particular, in the context of targeting a Baa2 credit rating for the actual company structure which is lower than the target the company proposed for the notional capital structure.
	PRT.RR.A3	Required	The company should provide further evidence and Board assurance to support the financeability of both the notional and actual company structures with particular reference to how the thresholds set out for the key financial ratios are consistent with the target credit ratings.	1 April 2019	Portsmouth Water has provided Board assurance to support the assessment of financeability. The Board has focused on 5 factors in order to make its assessment: - ability to finance the capital programme; - mitigation for risks associated with the Havant Thicket Water Storage Reservoir; - sufficient resilience to other financial shocks; - balance between financeability and bill levels; and - downward pressure on ratings as a result of the level of allowed return.	Intervention required. Portsmouth water has provided evidence to support the key financial ratios with the target thresholds it considers consistent with its target credit rating of Baa2/BBB albeit with limited headroom. Following interventions across the business plan we consider a smaller increase to PAYG rates is sufficient for Portsmouth Water to be financeable for the notional company.	We are intervening to remove the 4.8 per cent increase to PAYG rates for the water resources control and we apply an increase of 0.7 per cent to PAYG rates for the water network plus control.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					In making its assessment, the company identified a financeability constraint on the basis of the notional company and proposes an increase in PAYG rates of 4.8 per cent, bringing forward £4.5 million of PAYG revenue from future periods to address the constraint. Portsmouth Water provides evidence including a third party report to support the increase based its revised business.	In our initial assessment of notional financeability for Portsmouth Water we exclude the Havant Thicket control as these costs are passed through to Southern Water customers. We also initially consider financial ratios excluding the PAYG increase proposed by the company. Excluding an adjustment to PAYG rates, we consider the financial ratios do not provide sufficient headroom to a minimum investment grade credit rating. However, we consider a smaller increase is appropriate to address the financeability constraint bringing forward £1 million of PAYG revenue from future periods. Consistent with our approach for other companies we consider the increase is best applied to the water network plus control.	
	PRT.RR.A4	Required	The company should provide further detail to explain how the RoRE range was determined for Havant Thicket, in particular how it relates to cost data in the bell curve provided in its plan, and provide further detail to explain how it has ensured the data underpinning the range of cost outcomes for Havant Thicket represents a robust assessment.	1 April 2019	Portsmouth Water says it commissioned expert third party analysis of costs associated with the prospective Havant Thicket Winter Storage Reservoir development. Monte Carlo modelling was used to inform P10 and P90 risk levels with the range of model outputs shown in the bell curve included in the company's business plan. Portsmouth Water says that the RoRE risk analysis included in its updated business plan reflects a more sophisticated understanding of risks and includes mitigations from the proposed commercial framework for the project which both improve upside and reduce downside scenario outcomes.	No intervention required. Portsmouth Water has responded satisfactorily to the requirement.	N/A.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	PRT.RR.A5	Required	The company should amend its assessment of revenue variance 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	Portsmouth Water says it has reviewed its initial analysis of revenue variance risk by performing bottom-up Monte Carlo analysis on historical data for the past decade. The company says it took account of new properties, unmeasured switchers and weather impacts. This resulted in a change in the RoRE risk range from -0.36% to 0.65% to a revised range of -0.37% to 0.33%.	No intervention required. Portsmouth Water has responded satisfactorily to the action. However, we note that the assumed revenue risk range is wide compared with assumptions made by other companies.	N/A.
	PRT.RR.A6	Required	There is inconsistency between the notional cost of equity in business plan table Wr5 and Wn5. The company should ensure its subsequent submission is consistent in this respect.	1 April 2019	Portsmouth Water amended its asset beta from 2 decimal places to 4 decimal places. This addresses the inconsistent cost of equity between the 2 tables.	No intervention required. We reviewed Portsmouth Water's updated business plan and the company has provided sufficient evidence that its cost of equity now matches between tables Wr5 and Wn5.	N/A
	PRT.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	Portsmouth Water says that it has a risk management framework to identify, manage, and mitigate risks, with oversight by the Board and senior management team. Risks are logged in the company's corporate risk register and Portsmouth Water has set out the principles for its risk management approach. Portsmouth Water says that it quantified the range of financial impacts using a variety of approaches including detailed modelling, analysis of historic outturn, forward looking projections and, where appropriate, expert opinion. The company says it then: • adjusted for risk mitigation; • undertook Monte Carlo simulations and calculations in the PR19 financial model; and • subjected findings to Board review and challenge.	No intervention required. Portsmouth Water has responded satisfactorily to the advised action.	N/A

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
PRT.RR.C1	Our decision to include a separate control in the company's draft determinations requires a separate allowance for taxation relating to Havant Thicket. Portsmouth Water has not provided any commentary relating to the tax treatment of capital expenditure on Havant Thicket.	We have set the tax allowance to zero in the separate control for Havant Thicket in the draft determination. We expect the company to provide updated tax information for each control as part of any representations on the draft determination along with evidence of the assurance, consistent with our expectations on the original business plan information. We have not taken account of the information on tax provided by Portsmouth Water for the Havant control in its query response to PRT-DD-RR-004 at this stage.
PRT.RR.C2	Our decision to include a separate control in the company's draft determinations requires an intervention associated with PAYG and RCV run-off rates for the Havant Thicket reservoir. We maintain the allocation of all expenditure to RCV as proposed by Portsmouth Water and we depreciate the RCV on a straight-line basis to an end date 80 years after the assumed start date for the bulk supply agreement of 1 April 2020. The company sets out a duration of 80 years for the agreement therefore we depreciate the RCV on a straight-line basis to an end date 80 years after the start of the agreement.	We adjust the PAYG and RCV run-off rates for the water resources control to remove the Havant Thicket reservoir costs.
PRT.RR.C3	Portsmouth Water's approach to PAYG rates is to recover in each year an amount equivalent to operating costs. The application of separate control for Havant Thicket and the 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 Portsmouth Water's stated approach.	We are making a technical intervention to align PAYG rates to Portsmouth Water's stated approach of recovering operating expenditure for each year for each wholesale control.
PRT.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.
PRT.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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July 2019

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