

July 2019

Trust in water

PR19 draft determinations

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

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

Table 1: SES 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	SES.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>SES Water has retained its assumed company-specific adjustment to its cost of capital in the revised plan. The company provides 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 the proposed uplift is unchanged at 25bp on the overall cost of debt.</p> <p>SES Water has provided additional representations supporting its claim to provide adequate compensating benefits to customers and that</p>	<p>Intervention required.</p> <p>Overall we consider the company has passed our Levels assessment but not our Customer Support or Benefits assessments – failing the criteria overall for receiving a company-specific adjustment.</p> <p>On our Benefits assessment, our own updated assessment shows a strongly negative net present value to providing the uplift. We conclude that there is not compelling evidence that there are benefits that adequately compensate customers for the increased cost of the uplift.</p>	We are intervening to apply our view of the sector cost of capital to the company's allowed revenues for draft determinations.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					<p>customers support funding its proposed uplift.</p> <p>The company argues that a third-party consultancy report supports that in theory small local companies should bring benefits. It also highlights its strong performance during a period where freeze-thaw caused supply interruption issues across England & Wales in early 2018.</p> <p>The company also surveyed 539 customers asking if they were content to continue to fund the £1.75 cost of providing the company's uplift, finding that 86% were content to do so.</p>	<p>Therefore, the company provides little in the way of new material; its estimates of benefit are not monetised. In the round we do not consider that the evidence the company provides amount to additional benefits which would change our overall conclusion.</p> <p>On our Customer Support assessment, the company framed its question as if customers are already paying for the uplift in their bills – this is not the case. We therefore consider that the high level of support elicited does not amount to compelling evidence of customer support overall.</p>	
	SES.RR.A2	Required	The company should provide a clear statement from the Board that the business plan is financeable on both the notional and its actual company structures.	1 April 2019	SES Water has provided a statement from the Board that the business is financeable on both the notional and actual company structures.	<p>No intervention is required.</p> <p>SES Water has completed the action.</p> <p>The company has provided a clear statement from the Board that the business plan is financeable on the basis of the notional and its actual company structures.</p>	N/A
	SES.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	<p>SES Water has provided further evidence of the steps taken by the Board to provide assurance of the financeability of the business in its initial assessment of plans response document and in response to the query raised.</p> <p>The steps include a review of the key financial ratios including the covenant ratios, review and consideration of various stress testing scenarios and the ability to withstand these cost shocks, and consideration of the ability to access additional borrowing required.</p>	<p>No intervention is required.</p> <p>SES Water has completed the action.</p> <p>We consider the Board has taken reasonable steps to assess the financeability of the business plan on the basis of the notional and its actual company structure.</p>	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	SES.RR.A4	Required	The company should provide further evidence that all of the financial ratios are consistent with the target credit rating on the notional structure.	1 April 2019	<p>SES Water states all of the financial ratios are consistent with the target credit rating for the notional financial structure.</p> <p>The company has provided a table to show AICR and gearing for the notional structure for the period 2020-2025 however the financial ratios do not match what the company has revised within the business plan data table App 10.</p> <p>In response to a query we raised following receipt of the revised business plan, the company provided additional evidence to explain the variance between the document and the business plan tables.</p>	<p>No intervention is required.</p> <p>SES Water has completed the action.</p> <p>SES Water has provided additional evidence that the financial ratios are consistent with the target credit rating on the basis of the notional structure.</p> <p>In response to a query raised, the company set its assurance that the business plan is financeable on the basis of the notional company structure. The Board considers the key financial ratios on both an appointed business basis (provided in the business plan tables) and a company-wide basis including the non-appointed business (provided in the initial assessment of plans response document).</p>	N/A
	SES.RR.A5	Required	The company should provide further evidence that the company is financeable on its actual structure, in particular in relation to its ability to maintain financial ratios in line with its debt covenants given the limited headroom set out in the plan.	1 April 2019	<p>SES Water has provided further evidence to support its Board assurance that the company is financeable on the basis of its actual structure. In particular, the company has provided an updated table showing projected financial ratios in relation to bond covenants.</p> <p>The specific interest cover ratio applied in the bond covenants shows no headroom against the minimum threshold required across the five years. SES Water sets out that it can maintain this interest cover ratio above the threshold by increasing its borrowing. Therefore, it considers headroom to the interest cover ratio is linked to the headroom in the gearing threshold also attached to the debt covenants and the company considers there is sufficient borrowing capacity over the life of the business plan.</p>	<p>No intervention but further action required.</p> <p>In response to a query we raised following receipt of the revised business plan, the company has provided additional evidence to support the Board assurance undertaken to maintain financial ratios in line with its debt covenants. SES Water puts significantly more weighting to the covenant gearing ratio threshold of 85 per cent which provides headroom to manage the covenant adjusted interest cover ratio. The company considers there is sufficient headroom against the gearing threshold. We remain concerned that using further debt as a mechanism to manage the covenants may have a negative impact on other financial ratios and financial resilience.</p>	Pursuant to action SES.LR.A4, we expect SES Water to confirm the level of gearing it expects to achieve on the basis of its actual structure and provide Board assurance to confirm how the financeability and financial resilience of the actual structure will be maintained in the context of our draft determinations.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
						<p>We are not intervening in SES Water's determination in respect of the financial ratios of its actual structure.</p> <p>We note that SES Water's Board assurance statement states that the company has significantly reduced regulatory gearing from approximately 77 per cent in March 2018 to approximately 60 per cent in March 2019. However, the financial ratios provided for the actual company structure in the revised business plan tables (App10) show gearing for all years of close to 70 per cent. The original business plan submitted showed gearing ranging from 62.5 per cent to 65 per cent.</p>	
	SES.RR.A6	Required	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.	1 April 2019	SES Water considers it is using the correct assumptions.	<p>Intervention required.</p> <p>SES Water states that it has used the correct assumption for the cost of debt for index-linked debt, being 2.32% CPIH deflated cost of debt and 0.25% premium consistent with the proposed company specific adjustment.</p> <p>This does not take account of the revised guidance set out in the 'Financial model and rule book' in relation to index linked debt to use the RPI deflated cost of debt in the early view cost of capital and the requirement to assess notional financeability before the application of any company specific adjustment to the cost of capital.</p>	We are intervening in our draft determinations for SES Water on the basis of the notional company structure to set the cost of debt and indexation for index-linked debt consistent with the sector cost of debt assumed in our draft determinations.
	SES.RR.A7	Required	<p>The company should remove the uncertainty mechanism for lead or provide convincing evidence it is necessary given the uncertainty provisions of the licence.</p> <p>The company should remove the uncertainty mechanism for business rates or provide convincing</p>	1 April 2019	SES Water says it has removed the proposed uncertainty mechanisms for changes in lead standards and business rates. It still considers that changes to these costs are outside of its control and could be	<p>No intervention required.</p> <p>SES has completed the required action by removing the uncertainty mechanism proposals.</p>	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
			evidence 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.		financially material but will rely on existing licence provisions.		
	SES.RR.A8	Required	The company should amend its overall assessment of RoRE outcomes or provide convincing evidence to explain why it is reasonable to assume totex outcomes should be asymmetrically skewed to the downside within an incentive based regime.	1 April 2019	SES Water says it has reviewed its overall RoRE risk range assessment which has resulted in a more symmetrical RoRE range, although some downside skew remains which it attributes to finance cost and totex risk factors.	Intervention required. SES Water has revised its assessment of its totex risk ranges. This has reduced the asymmetric skew to the downside. However, our view is that an efficient company should be able to achieve the base equity return on its notional structure.	SES Water should consider whether any revisions to its RoRE risk range should be made in response to the draft determination.
	SES.RR.A9	Required	There is inconsistency between the notional cost of equity in financial model and data tables. The company should ensure its subsequent submission is consistent in this respect.	1 April 2019	SES Water has advised that data tables and financial model are now consistent and complete.	No intervention required. We reviewed SES Water's updated data tables and financial model and we can confirm the company has provided sufficient evidence that the financial model has been updated to match the data tables.	N/A
	SES.RR.B1	Advised	The company should provide a clearer link between its internal risk management and mitigation procedures and introduce this into the RoRE analysis.	1 April 2019	In its response SES Water says that it has further aligned its internal risk management and mitigation procedures and mapped the relevant mitigating processes and controls to its RoRE analysis, with results reflected in the risk and return areas of its updated business plan.	No intervention required. SES Water has responded adequately to the action. While the additional information provided is mainly at a high level, this was in response to an 'advised' rather than 'required' action.	N/A

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
SES.RR.C1	SES 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 SES Water's stated approach.	We are making a technical intervention to align PAYG rates to SES Water's stated approach of recovering operating expenditure for each year for each wholesale control.
SES.RR.C2	We are intervening to adjust SES Water's risk range for the cost of new debt to 75 bps on the upside and 50 bps on the downside. This is consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt and takes account of our decision not to allow SES Water's proposal for a company specific adjustment to its cost of capital for 2020 to 2025.	We are intervening to adjust SES Water's risk range for the cost of new debt to 75 bps on the upside and 50 bps on the downside. This intervention is consistent with the PR19 methodology. It is also consistent with historical data on bond issuance costs in the sector compared to our benchmark index for the cost of new debt. However, as set out in the Risk and return technical appendix, we are considering the assessment of debt cost risk further for the final determination.
SES.RR.C3	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.
SES.RR.C4	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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