

July 2019

Trust in water

PR19 draft determinations

**South East Water – Aligning risk and return
actions and interventions**

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

Table 1: South East 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	SEW.RR.A1	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	South East Water says that, having reviewed its assessment of totex risk, it has decided not to change the RoRE risk ranges in its business plan (other than as a consequence of other input changes). South East Water sets out a view that some risks, such as those associated with severe weather and asset health, do not have upside components. This leads to an overall downside skew to its totex risk range at P10/90 levels (although it considers the totex incentive regime may drive some cost outperformance in the middle of the risk distribution). It also refers to challenging cost allowances for PR19.	Intervention required. The company has provided its arguments for the downside skew in its RoRE risk range for totex. However, our monitoring financial resilience report for 2018 shows that South East Water has achieved cost outperformance of 1.5% measured in RoRE terms in 2015-18; which is greater than the overall upside South East Water considers possible on a P90 basis in its business plan.	The company should consider further its assessment of its totex range in response to the draft determination in the context of its reported past performance.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	SEW.RR.A2	Required	The company has targeted a credit rating for its actual corporate structure that is one notch above a minimum investment grade. The company should provide further evidence, with Board assurance, 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	<p>The company has provided further evidence to support the target credit rating for the notional company. The company sets out that it has been able to issue a significant value of debt through a number of tranches at what it considers to be a reasonable cost of debt.</p> <p>The company has also committed to inject equity in 2019/20 to reduce gearing to 75 per cent with evidence of support from investors.</p>	<p>Intervention required.</p> <p>South East Water has completed the action. In particular the company has provided evidence of its recent fund raising through a number of tranches at a reasonable cost of debt, as well as the protection provided by the covenanted debt structure, alongside the commitment to provide an equity injection to de-gear to 75 per cent.</p> <p>However, we consider that certain financial ratios provide limited headroom against the target credit rating which in turn provides just one notch headroom to a minimum investment grade rating as set out in 'Aligning risk and return technical appendix'.</p> <p>We are not intervening in respect of the financial ratios achieved under South East Water's actual financial structure in our draft determinations as it is South East Water that is responsible for ensuring it maintains financial resilience and the financeability of its activities over the long term.</p>	Pursuant with action SEW.LR.A5 on financial resilience we expect the company to provide further assurance that the targeted gearing level and credit rating for its actual financial structure are consistent with maintaining financial resilience in the long term.
	SEW.RR.A3	Required	There is an inconsistency between the business plan and the business plan tables; the company should clarify the target credit rating for the notional company.	1 April 2019	The company has confirmed the target credit rating for the notional company is Baa1 and the business plan data table App10 has been corrected to reflect this.	<p>No intervention required.</p> <p>South East Water has completed the action.</p>	N/A
	SEW.RR.A4	Required	<p>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. The company should reconsider or reduce the scope of the PAYG adjustment in the context that:</p> <ul style="list-style-type: none"> The adjustment should clearly address only a notional financeability constraint. 	1 April 2019	The company has provided evidence to support the calculation of the "natural" PAYG and RCV run-off rates. The company has provided a third party report as evidence to support the adjustment to PAYG rates to address a constraint the company has identified on the basis of the notional company.	<p>No intervention required.</p> <p>South East Water has completed the action.</p> <p>The company has adjusted the increase to PAYG rates to</p>	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
			<ul style="list-style-type: none"> Evidence that underpins the cost of capital for the 2025-30 bill profile should be compelling, to ensure the company's conclusion that its' chosen bill profile reflects customers' preferences is robust. The company should consider revising the bill profile for 2020-30 if appropriate to maintain customer preferences for stable bills. 			<p>be in line with the level required to address the assessed financeability constraint for the notional company. South East Water has provided sufficient evidence to support the level of the adjustment.</p> <p>We note that South East Water has reduced the weighted average cost of capital it has used to calculate bills for 2025-30. This is at the high end of the range set out in our early view cost of capital, and is above the upper end of the range in our updated view. However we accept the rationale for the pull forward of revenue in 2020-25 on the basis of the financeability assessment.</p>	
	Advised actions	Advised	No actions required.	N/A			

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
SEW.RR.C1	South East Water's approach to setting PAYG rates is to recover operating expenditure and capitalised infrastructure renewal 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 South East Water's stated approach.	We are making a technical intervention to align PAYG rates to South East Water's stated approach of recovering operating expenditure plus capitalised infrastructure renewal expenditure for each year for each wholesale control.
SEW.RR.C2	We are intervening to adjust South East Water's risk range for the cost of new debt to 100 bps on the upside and 25 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.	We are intervening to adjust South East Water's risk range for the cost of new debt to 100 bps on the upside and 25 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.
SEW.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.
SEW.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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July 2019

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