

July 2019

Trust in water

PR19 draft determinations

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

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

Table 1: South Staffs 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	SSC.RR.A1	Required	The company's appointee WACC is 0.01% higher than our 'early view'. It should alter its business plan table inputs to derive the required 5.47% nominal figure.	1 April 2019	South Staffs Water confirms it has altered its business plan tables to derive the required 5.47% nominal figure.	No intervention required. We reviewed South Staffs Water's updated business plan and the company has provided sufficient evidence that it has updated their tables to match our 'early view' WACC.	N/A
	SSC.RR.A2	Required	The company should revise its assessment of revenue risk in its RoRE analysis, or provide convincing evidence that its exposure to revenue variation is as wide as its analysis suggests, particularly given the revenue forecasting incentive mechanism set out in the PR19 methodology.	1 April 2019	South Staffs Water has reviewed its RoRE risk range for revenue. In light of the revenue forecasting incentive, it has eliminated the risk range for the water resources and network plus price controls, but retained some risk range for the retail revenue price control because it is not a total revenue control. Its RoRE risk range for revenue is reduced to +/-0.1%.	No intervention required. South Staffs Water has satisfactorily responded to this requirement.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	SSC.RR.A3	Required	<p>The company should set out the steps taken and the assurance obtained by the board in order to assess financeability of the business plan. In particular the consideration given, and the action taken, to the recommendation of the third party report to engage with investors in relation to their deteriorating financial ratios.</p>	1 April 2019	<p>South Staffs Water sets out the involvement of the investor appointed non-executive directors in the development of the business plan and has resubmitted its Board assurance statement which sets out the discussions held within Board meetings in relation to financeability.</p> <p>The Board and the company's investors have addressed the declining ratios through the use of financial levers (an increase to PAYG rates) which increases average bills from £144 to £147, considering this enables the company to maintain an investment the target credit metrics for each year of the period.</p> <p>The Board has also reviewed and considered the independent assurance report in relation to the financial modelling carried out on the target credit metrics.</p>	<p>Intervention required.</p> <p>South Staffs Water has provided further evidence of the steps undertaken to provide Board assurance of the financeability of the business plan on the basis of the notional company. The company has increased its target credit rating for the notional company to provide two notches headroom to a minimum investment grade rating and in doing so, identified a financial constraint.</p> <p>South Staffs Water's proposes a bill profile that results in a deterioration of financial ratios over the life of the plan and the company proposes increasing PAYG rates to ensure the plan achieves target financial metrics in each year.</p> <p>The Board and the company's investors address the declining ratios through an increase to PAYG rates which increases average bills from £144 to £147, considering this enables the company to maintain an investment the target credit metrics for each year of the period. The company considers the use of financial levers is appropriate to provide a bill profile consistent with customer preferences.</p> <p>As set out in action SSC.RR.A7, we do not consider the company has provided sufficient evidence that bill profiles over 2020-30 are consistent with customer preferences and therefore that the PAYG is appropriate. In our assessment of notional financeability, we do not consider the increase to PAYG rates is necessary for the company to maintain sufficient headroom to a minimum investment grade credit rating.</p>	<p>We are intervening to remove the proposed increase to PAYG rates to address a notional financeability constraint and to provide a smooth transition of bills between 2020-25 and 2025-30 as set out in section 4.2 of South Staffs Water's draft determination summary document.</p>

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	SSC.RR.A4	Required	The company has targeted a credit rating for the notional company that is one notch above the minimum investment grade and lower than the target for its actual structure. The company should provide evidence to support its view that this is reasonable for the long term financeability of the notional company or provide appropriate sensitivities to the actions set out in the business plan that could be taken to secure the long term financeability of the notional company.	1 April 2019	<p>South Staffs Water has revised its target credit rating for the notional company to two notches above the minimum investment grade (Baa1/BBB+ (Moody's/S&P)). The company sets out that two notches headroom will maintain the current level of credit quality and provide headroom to enable the company to remain financially resilient.</p> <p>South Staffs Water also considers this is the target rating that Ofwat uses in assessing the cost of debt component of the weighted average cost of capital.</p>	<p>Intervention required</p> <p>South Staffs Water sets out the basis for its revised target credit rating and provides key financial ratios that appear consistent with the target credit rating for the notional structure. The company also provides adjusted cash interest cover ratio and funds from operations/debt for the period 2020-30 which are above target thresholds. The ratios include a PAYG adjustment to bring revenue forward.</p> <p>South Staffs Water identify a financeability constraint for the notional company and applies an increase to PAYG of on average 3.0% weighted towards earlier years. The basis of the constraint is that financial ratios do not achieve the target threshold for all years of the period, with ratios declining due to the bill profile which reduces on a real basis.</p> <p>Following our assessment of notional financeability for the draft determinations including our interventions across the plan, we do not consider an adjustment to PAYG rates is required. At the initial assessment stage, we set out that while we consider the trend of financial metrics, we do not consider individual ratios in isolation or individual years.</p>	We are intervening to remove the proposed increase to PAYG rates to address a notional financeability constraint and to provide a smooth transition of bills between 2020-25 and 2025-30, as set out in section 4.2 of South Staffs Water's draft determination summary document.
	SSC.RR.A5	Required	The company should provide further evidence that the plan is financeable on its actual structure, in particular to support its view that the weak financial ratios are temporary and will be reversed at PR24.	1 April 2019	<p>South Staffs Water sets out that after applying the PAYG adjustment, Moody's calculation of the adjusted interest cover ratio averages 1.5x over the period. The company states this is equal to the target credit rating of Baa1.</p> <p>South Staffs Water also sets out that the ratio declines over the period as a result of re-profiling the bill to provide a stable bill in nominal terms. The ratio is forecast to recover to 1.5x each year</p>	<p>Intervention required</p> <p>South Staffs Water's financial ratios on the actual company structure are generally stronger than for the notional company structure, but show a similar declining trend over the period with the Moody's adjusted cash interest cover ratio ending at 1.5x in 2025. The company sets out that it has carried out further modelling for the period 2025-30</p>	South Staffs Water sets out that the business is consistent with the target credit rating after the application of the proposed PAYG adjustment to solve a notional financeability constraint,

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					over the period 2025 to 2030 as the company is not adopting the same bill profile for that period.	<p>and that this ratio is above 1.5x for each of the years modelled, but does not provide the actual ratios.</p> <p>The financial ratios are consistent with the target credit rating for the actual structure. However, the ratios are calculated based on PAYG rates including the proposed adjustment to address the notional financeability constraint identified by the company.</p>	<p>Following our assessment of financeability, we are intervening to remove this proposed adjustment. South Staffs Water should set out the impact of this on its actual financeability and long term financial resilience.</p> <p>Pursuant to action SSC.LR.C1 (PR19 ('South Staffs Water Securing Long-term resilience actions and interventions') the company should provide further Board assurance that the company will remain financeable and can maintain financial resilience for the actual structure.</p>
	SSC.RR.A6	Required	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.	1 April 2019	South Staffs Water sets out that RCV run-off rates are equivalent to the current cost depreciation on existing assets plus depreciation on capital additions during the period using an appropriate average life for the assets. The company provides details of the current cost register, the average asset lives and the treatment of infrastructure renewals expenditure.	<p>No intervention required.</p> <p>South Staffs Water has provided sufficient evidence of the approach and calculation of its RCV run-off rates.</p>	N/a
	SSC.RR.A7	Required	The company should provide further evidence that the bill profile over 2020-25 and beyond is consistent with customer preferences given the uncertainty over proposed reconciliation adjustments at PR24.	1 April 2019	<p>On re-testing its 2020-25 bills with customers South Staffs Water received 80% support for the bill profile.</p> <p>The company also separately tests bills over the period 2020-30 with different profiles to transition between 2020-25 and 2025-30. The company</p>	<p>Intervention required</p> <p>As set out in action SSC.AV.A2 ('South Staffs Water Addressing affordability and vulnerability') we do not consider that South Staffs Water has provided convincing evidence that the bill profile</p>	We are intervening to remove the proposed increase to PAYG rates to address a notional financeability

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					<p>states that customers support a flat bill profile over 2020-25 and increases up to £3 thereafter. However, 66% of customers prefer a profile that rises incrementally, with only 34% preferring a flat bill in the 2020-25 period followed by greater increases in the 2025-2030 period.</p> <p>The company places greater weight on the 2020-25 preference and proposes a mechanism to keep any increase below £3. This mechanism includes increasing PAYG rates during 2020-25 to bring revenue forward from future and provide a smoother transition of bills between periods.</p>	<p>selected is consistent with customer preferences for bills over the long term.</p> <p>The company does not select the bill profile that is most acceptable to customers, maintaining that evidence of 80% support for a flat nominal bill profile in 2020-25 means it should implement that.</p>	<p>constraint and to provide a smooth transition of bills between 2020-25 and 2025-30, as set out in section 4.2 of South Staffs Water's draft determination summary document.</p> <p>We set out further explanation of our decision to reject South Staffs Water's bill proposal in sections 4.2 and 6.1 of the company's draft determination summary document.</p> <p>In setting the bill profile for the draft determination we give consideration to maintaining movements in bills of less than £3 as set out in the customer engagement.</p>
	SSC.RR.B1	Advised	The company should provide a clearer link between its internal risk management and mitigation procedures and its RoRE analysis.	1 April 2019	South Staffs Water has provided further details of its risk management process in its revised business plan. As part of the information provided on the company's approach to ensuring corporate and financial resilience it has provided links between key risks identified and the RoRE impact scenarios it has modelled.	No intervention required. The company has provided a satisfactory response to this requirement	N/A.

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
SSC.RR.C1	We consider South Staffs Water's revised RoRE risk range for ODIs to be excessive, in light of the range in its original plan submission for which Monte Carlo simulation was used to take account of covariance.	We are intervening to use South Staffs Water's original RoRE risk range submission for ODIs. We expect the company to reconsider the RoRE risk range for ODIs in its response to the draft determination.
SSC.RR.C2	South Staffs 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 South Staffs Water's stated approach.	We are making a technical intervention to align PAYG rates to South Staffs Water's stated approach of recovering operating expenditure for each year for each wholesale control.
SSC.RR.C3	We are intervening to adjust South Staffs 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 reduce South Staffs Water's financing risk range associated with 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.
SSC.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.
SSC.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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