July 2019

Trust in water

PR19 draft determinations

Southern Water – Aligning risk and return actions and interventions

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

Table 1: Southern 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	SRN.RR.A1	Required	The company targeted a credit rating for the notional company with that is one notch above a 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 actions that could be taken to secure the long term financeability of the notional company.	1 April 2019	The company has provided information to show that the notional financial structure post the IAP, is financeable against a target credit rating of Baa1, one notch higher than the September submission which had a notional credit rating of Baa2. The company has provided two versions of Moody's rating matrix for the adjusted interest cover ratio, showing Baa1 with the inclusion of the PAYG adjustment, and Baa2 without it.	No intervention required. The Board as provide assurance that it has targeted a credit rating of Baa1 on a notional basis. Our PR19 methodology notes that different credit rating agencies adopt different approaches to their credit rating assessment, however we retain the view that cashflows brought forward by PAYG adjustments can help to mitigate a financeability constraint so long RCV is not depleted and the bring forward of revenue is supported by customer preferences.	N/A.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	SRN.RR.A2	Required	The company should provide further evidence to support the calculation of PAYG rates and demonstrate that the rates are consistent with the approach set out in the business plan.	1 April 2019	The company has provided further information to explain the approach to calculating PAYG rates. The company's approach to PAYG is to recover all costs required to maintain the operating capability of the company. This results in an approach that recovers a higher proportion of total expenditure from current customers compared to the approach adopted by other companies in the sector. The company has provided insufficient evidence that its approach provides a fair balance of cost recovered between current and future customers.	Intervention required. Southern Water has provided insufficient evidence to complete the action. The company has provided further evidence to support its approach to PAYG rates including in response to a further query on this issue. The company has allocated reactive renewals, IT expenditure relating to maintaining corporate systems and expenditure related to studies, investigations and inspections not specifically related to the location and construction of a new project to PAYG. This approach, along with RCV run-off rates which are relatively high in comparison with the rest of the sector, results in the company recovering a higher proportion of capital expenditure in the price review period than other companies. However, it is not clear why only current customers should pay for all costs required to maintain the operating capability of the company when future customers may also benefit from the expenditure.	We are intervening to reduce PAYG rates by an average of 5.7% to align with our view of operating expenses and infrastructure renewal expenses as a proportion of totex in the draft determination This reduces revenue in the period by £182m. As a consequence of our PAYG intervention we have not needed to make the technical intervention to PAYG rates as we have aligned these directly to our view of totex.
	SRN.RR.A3	Required	The company should set out how the approach to setting RCV run-off rates reflects the underlying RCV for the company for each wholesale control and provide more evidence to demonstrate that the rates are consistent with the company's approach.	1 April 2019	The company provides evidence to show the RCV run-off rates have been set with reference to the historic rate of depreciation against the underlying RCV for each control. The result has been tested against a current cost accounting depreciation charge for each price control. Southern Water's RCV run-off rates are based on an average asset life calculated by comparing historical cost depreciation including intangible assets to RCV values for each control.	No intervention required. Southern Water has provided further evidence in relation to its RCV run-off rates however, there is insufficient convincing evidence that the RCV run-off rates are appropriate. In response to a query, Southern Water provided further evidence to support the calculation of RCV run-off rates and the impact of the PAYG approach to average asset lives. The average asset life in the resubmitted business plan is calculated as 19.5 years and in the response to the query as 28.4 years for non-PAYG assets. We remain concerned that the	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
						calculation of average asset lives is not consistent with the approach to PAYG rates. We consider our assessment of financeability in the round, and therefore have not intervened on RCV run-off when combined with the substantial intervention we have made to PAYG rates as per action SRN.RR.A2.	
	SRN.RR.A4	Required	The company should provide further evidence that the level of the proposed adjustments to RCV run-off rates do not result in overall revenue being transferred between price review periods and are supported by customer preferences.	1 April 2019	The company states it has used RCV run off to smooth bill profiles between price review periods and more closely align the water and waste water bills, in line with the customer research and preferences. The company states it provides evidence in the financial model that adjustments are NPV-neutral	No intervention required. As per SRN.RR.A3. The company provides sufficient evidence and sets out that the adjustments are to balance the change to bills for water and wastewater customers and provides sufficient evidence that this does not move revenue between price review periods.	N/A
	SRN.RR.A5	Required	The company should check that the base RoRE value of 3.8% shown in the business plan has been calculated correctly and amend/re-present if necessary.	1 April 2019	The company has updated the base RoRE value in its business plan resubmission to 4.01%, consistent with ‘early view’ value for cost of equity for the notional company	No intervention required. The company has provided sufficient evidence to complete the action for the purposes of its RoRE presentation in the revised business plan.	N/A
	SRN.RR.A6	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 for a notional company within an incentive based regime.	1 April 2019	The company states that in the first three years of AMP6, it has underperformed allowed totex by a small margin of the order of 10bp in RoRE terms. It considers the PR19 cost challenge is tougher than PR14, with step changes required to achieve upper quartile operational performance without a ‘glide path’. The company considers a tough cost challenge combined with a challenging frontier shift assumption makes totex outperformance less likely than in 2015-20. Furthermore, after the initial assessment of business plans, the company considers it has been challenged with additional cost allowance reductions of around 20%, further reducing the potential for totex outperformance during PR19.	No intervention required. The company presents a totex RoRE range of -1.28% to +1.11% which is broadly symmetric. We consider that efficient companies should be able to achieve the base equity return on the notional structure; however it is not unreasonable for inefficient companies to forecast greater scope for underperformance. We address these issues further in the ‘Risk and return technical appendix’	N/A
	SRN.RR.B1	Advised	Acknowledging the explanatory material that the company has provided on its assessment of P10/P90 values for RoRE risk scenarios, and that	1 April 2019	Southern Water says that its outcome delivery incentive upside range is	No intervention required. Southern Water has adequately responded to the advised action.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
			values have been presented on a post-mitigation basis, please provide views on why Southern's risk ranges are relatively low, compared to the majority of companies.		limited by the findings of its customer research. It has also updated its totex ranges to indicate more upside potential, but it still considers that its analysis presents a fair view of the risks it faces. The company considers that the probability of all the individual P10/P90 RORE ranges occurring simultaneously would be significantly lower than the probability of an individual P10/90 risk materialising. The company considers its approach to combining multiple low probability but significant events accounts for an apparently lower RoRE range, rather than large inherent differences in risks.		

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
SRN.RR.C1	The RoRE risk range for C-Mex in Southern' Water's revised business plan exceeded the range implied by the revenue exposure limit for this incentive.	We are intervening to adjust Southern Water's risk range for C-Mex so that it is consistent with the retail revenue exposure limits of +/-12% applicable to this incentive.
SRN.RR.C2	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.
SRN.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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