

July 2019

Trust in water

PR19 draft determinations

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

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

Table 1: Thames 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	TMS.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 for a notional company within an incentive based regime.	1 April 2019	Thames Water says that it considered changing to a scenario that modelled additional outperformance due to further accelerated innovation. However it says that as its revised business plan contains significant additional stretch, this upside opportunity has been accounted for so it has not amended the upside or downside RoRE risk range for totex.	No intervention but further action required. The company has provided an explanation for the downside skew to its RoRE risk range for totex. The company presents a totex RoRE range of -1.48% to +0.64%. 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'	Thames Water should consider whether any revisions to its RoRE risk range should be made in response to the draft determination

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	TMS.RR.A2	Required	The company should provide further evidence of how the Board has assured itself that the company remains financeable on its actual capital structure given the level of the S&P funds from operations: net debt ratio and the business plan setting out that this will continue through the next price review period.	1 April 2019	<p>The company has commissioned a third party report to re-review the financeability and report to the Board on the assessment of financeability based on a notional and actual company structure. The third party has also reviewed the company's ability to maintain the preferred credit rating.</p> <p>The Board assurance statement states: "we have, and will continue to, strengthen our funding from operations (FFO) to net debt ratio from 4.8% to 6.1% to protect customers' interests in both the short and longer term. We also obtained independent specialist assurance that this approach ensures we remain financeable on both an actual and notional basis".</p> <p>The company provides evidence that its ability to access markets is further supported by the substantial liquidity facilities it maintains with creditworthy counterparties, the support of its relationship bank group, and the support of shareholders. The company has provided evidence of support that it will be able to raise debt as required from its bank group.</p>	<p>No intervention but further action required.</p> <p>The report provides sufficient evidence to support the notional target credit rating and references that for the actual structure, the company benefits from a one notch uplift due to the securitised structure. The third party states Standard & Poor's has not provided clear guidance on what would trigger a downgrade so some estimates have been used within the report which we consider as part of our assessment of financial resilience.</p> <p>However, the level of FFO/Debt for the actual company remains tight.</p>	Pursuant with action TMS.LR.A4 on financial resilience we expect Thames Water to provide additional Board assurance that it will remain financeable in 2020-25 on both the actual and notional company structure in the context of interventions in our draft determination and reasonably foreseeable range of plausible outcomes of its final determination.
	Advised actions	Advised	There are no advised actions.	N/A			

Table 2: Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
TMS.RR.C1	Thames 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 Thames Water's stated approach.	We are making a technical intervention to align PAYG rates to Thames Water's stated approach of recovering operating expenditure for each year for each wholesale control.
TMS.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.
TMS.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 initial assessment of plans, 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.
TMS.RR.C4	Our initial assessment of financeability, prior to intervening, is that financial ratios in the round do not provide sufficient headroom to a minimum investment grade credit rating. Prior to the intervention, our assessment of key financial ratios suggests there is insufficient headroom to a minimum investment grade. We consider the intervention is necessary to ensure financeability on the notional structure following our interventions elsewhere in the draft determination including the lower current view of the cost of capital.	We are intervening to increase the company's PAYG rates for each year for the water and wastewater network plus controls by 0.7%, advancing revenue of £41 million from future customers. We consider the use of financial levers is an appropriate method to address the notional financeability constraint in this instance. We discuss our approach to addressing financeability constraints in the 'Aligning risk and return technical appendix'.

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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

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