

July 2019

Trust in water

# PR19 draft determinations

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

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

**Table 1: Wessex 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	WSX.RR.A1	Required	The company should revise its business plan and associated financial modelling to be based on our 'early view' of cost of capital or provide compelling evidence why this is not appropriate.	1 April 2019	Wessex Water has updated the cost of capital assumption at appointee level to the central estimate of our credible range published in December 2017.	No intervention required. We have reviewed Wessex Water's updated business plan and the company has provided sufficient evidence that it has used the cost of capital from our 'early view' in the PR19 final methodology.	N/A
	WSX.RR.A2	Required	The company should provide further evidence of the assumptions used to derive the notional company when calculating the financial ratios provided in the business plan tables or provide further ratios consistent with the PR19 financial model for the notional company as set out in the methodology.	1 April 2019	The company states it has updated the cost of capital assumption at appointee level to be 2.4%, consistent with the early view stated in the PR19 final methodology.  The company has confirmed that the assumptions used on notionally geared structure are 60% opening gearing, 33% opening index linked debt, cost of debt	No intervention required. Wessex Water has completed the required action.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					set at Ofwat's blended rate consistent with the WACC, dividend yield set at the equivalent to the allowed real cost of equity. These assumptions are consistent with those set out in the PR19 methodology.		
	WSX.RR.A3	Required	The company should reassess financeability on its actual structure and provide a board statement based on a business plan underpinned by an appropriate cost of capital. The company should set out the steps taken and the assurance obtained by the board in order to provide the statement, including, with supporting evidence, the threshold levels for key financial ratios.	1 April 2019	The company states it has updated its cost of capital to be consistent with the early view set out in the PR19 final methodology, which underpins the financeability assessment in the revised plan. The board has approved a new board assurance statement having included consideration of the financial ratios that are derived from Ofwat's financial model and the target thresholds. The company's audit and risk committee also considered the above items and advised the board accordingly.	Intervention required. Wessex Water has provided further evidence in relation to the action including an updated Board statement that the company is financeable on the notional and its actual company structure. On its actual structure, the company has targeted credit ratings of Baa1 (Moody's) and BBB+ (Fitch). We note that the company targets a threshold for FFO/Debt for S&P at > 6% which is lower than the threshold of 9% set out in S&P's recent rating affirmation for Wessex Water (November 2018). We also note that the actual FFO/Net debt ratios average <9% in the business plan.	We expect Wessex Water to provide further evidence to support the Board's assurance that the company is financeable in relation to its actual company structure and should set out the steps to be undertaken to address the weak FFO/Debt ratio relative to the target credit rating of BBB+ for S&P, taking account of our draft determination.
	WSX.RR.A4	Required	The company should provide further evidence of how a "robust investment grade" credit rating is appropriate for the notional and its actual company structure in relation to its investment needs, the approach of credit rating agencies, its current credit rating or the licence requirement to maintain a minimum investment grade credit rating.	1 April 2019	The company states that targeting a "robust credit rating" is consistent with the company's obligation to take all reasonable measures to ensure an investment grade credit rating. The company provides evidence that its plan targets Baa1 (Moody's) and BBB+ (Fitch) ratings. The company notes that under Ofwat's notional capital structure interest covers are below the level required for a Baa1 rating but that financing a proportion of new debt on an index linked basis would mitigate this.	No intervention required. Wessex Water has completed the action. The company has set out that the company targets credit ratings of Baa1/BBB+ (Moody's/Fitch) for the notional and its actual company structure, in line with the "robust credit rating" targeted in the original business plan. However, we expect the company to respond to action WSX.RR.A3	N/A
	WSX.RR.A5	Required	The company should ensure consistency of the information on RoRE analysis submitted in App26 and elsewhere in its plan, or reconcile the differences between the third party report and the data submitted in business plan table App26.	1 April 2019	Wessex Water says that it is now consistently referring to RoRE risk range values calculated in the PR19 financial model using inputs from data template App26.	No intervention required. The company has responded satisfactorily to the action.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	WSX.RR.B1	Advised	The company should provide a clearer link between its internal risk management and mitigation procedures and the RoRE analysis.	1 April 2019	Although Wessex Water referred to this action in its completed actions template, there does not appear to be any corresponding information in its response document although the action number is noted alongside WSX.RR.A5 (above).	No intervention required but Wessex Water should consider responding to this advised action.	Wessex Water should address this action in its response to our draft determination.

**Table 2: Further interventions for draft determinations**

Intervention reference	Our assessment and rationale	Interventions
WSX.RR.C1	In the original business plan, Wessex Water states its approach to revenue recovery is that 'the company is funded for all wholesale operating expenditure and all infrastructure renewals and repairs on a PAYG basis' and in its response to the IAP stated that 'we have updated PAYG rates to reflect the revised totex programme'. However, it appears that the company has not taken into account the deduction for grants and contributions allocated to operating expenses in the calculation of PAYG rates for water and wastewater network plus controls.	We are making a technical intervention to align PAYG rates to Wessex Water's stated approach of recovering all wholesale operating expenditure and all infrastructure renewals and repairs expenditure net of grants and contributions within operating expenditure.
WSX.RR.C2	We considered the RoRE risk range for financing new debt included by Wessex Water in its business plan submission to be excessive, taking account of our analysis of sector bond issuance costs since April 2015, compared to our benchmark index.	For the draft determination we are intervening to reduce Wessex 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. 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.
WSX.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.
WSX.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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