

December 2019

# PR19 final determinations

**Dŵr Cymru – Aligning risk  
and return final decisions**

**o f w a t**

[www.ofwat.gov.uk](http://www.ofwat.gov.uk)

## PR19 final determinations: Dŵr Cymru – Aligning risk and return final decisions

In our [draft determinations](#) we published the ‘Aligning risk and return actions and interventions’, the ‘Securing long-term resilience actions and interventions’ and the ‘Securing confidence and assurance actions and interventions’ document for each company. This set out the required and advised actions in our initial assessment of plans, a summary of the company’s response to the action, our assessment of the company’s response, and any further interventions we made as part of the draft determination.

This document sets out the decisions we are making for the final determination in response to representations received from companies on our draft determinations and changes for the final determination that are not resulting from representations received. We set out our response to thematic representations and representations from other stakeholders within the ‘Aligning risk and return technical appendix’ and the ‘Allowed return on capital technical appendix’. Our ‘Allowed revenue appendix’ for the company is published alongside this document. These documents are intended to be fully consistent. In the event of any inconsistency, the other documents listed above take precedence over this document.

Table 1 below sets out the action/intervention reference, our assessment and rationale for the draft determination, a summary of the company representation, our assessment and rationale for the final determination and our decisions for the final determination.

Table 2 sets out any further decisions that are not resulting from an action and/or representation which we are making as part of the final determination.

Each action has a unique reference. The prefix ‘WSH’ denotes the company Dŵr Cymru. The central acronym references the test area where the action has been identified, please see the ‘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. Draft determination interventions not resulting from an initial assessment of plans action are preceded with a ‘C’ and new interventions for the final determination not related to a previous action are preceded with a ‘D.’ For all other documents related to the Dŵr Cymru draft determination, please see the [final determinations webpage](#).

**Table 1: Dŵr Cymru – Representations in response to the draft determination**

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	WSH.RR.A1	The company should remove the uncertainty mechanism for business rates or provide compelling evidence to support the proposed uncertainty mechanism to support its view that adequate protections are not already in place given totex cost sharing arrangements. If the company retains an uncertainty mechanism in its revised business plan, it should ensure the proposal is underpinned by RoRE assessment in accordance with section 10.4.3 of the PR19 methodology.	No Intervention required.	No representation made.	No change for the final determination.	N/A

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	WSH.RR.A2	The company should provide further evidence on whether it is reasonable to assume totex outcomes (in RoRE risk analysis) should be asymmetrically skewed to the downside or provide compelling evidence that this is an appropriate assumption within an incentive based regime.	<p>No intervention but action required.</p> <p>Our view is that an efficient company should be able to achieve the base equity return on the notional structure.</p> <p>Dŵr Cymru should consider necessary revisions to its overall RoRE range in response to the draft determination.</p>	<p>Representation made.</p> <p>Dŵr Cymru provides updated App26 values for RoRE risk ranges in its representation on the draft determination. It sets out a view that the expected distribution of cash flows around the draft determination projections is heavily skewed to the downside and comments that other risks, not captured in Ofwat's analysis, are also asymmetrically distributed to the downside, notably regulatory and political risk.</p>	Change for the final determination.	See WSH.RR.D4
Risk and return	WSH.RR.A3	The company has targeted a credit rating for the notional company that is one notch above the minimum for 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.	<p>No intervention required</p> <p>The company has amended its target credit rating for the notional company structure to provide two notches of headroom to the minimum investment grade based on a review of other company's business plans. A credit rating two notches above the minimum investment grade provides additional resilience for the company to withstand cost shocks.</p>	No representation made.	No change for the final determination.	N/A
Risk and return	WSH.RR.A4	The company should provide further evidence that the business plan is consistent with the target credit rating on its actual corporate structure, in particular setting out threshold levels for key financial ratios and how these are consistent with the target credit ratings.	<p>Intervention required.</p> <p>Dŵr Cymru has set out the thresholds for certain financial ratios that have been used to assess actual company financeability. However, the financial ratios for adjusted interest cover and for FFO/Net debt set out in the revised business plan tables, including the company specific additional financial ratios, do not achieve these thresholds.</p> <p>The company sets out that the covenanted debt structure provides a one notch uplift to the credit rating and that the credit metrics are consistent with a BBB+/Baa1/BBB+</p>	<p>Representation made.</p> <p>The company provides representations that the Board is unable to provide assurance that the draft determination is financeable.</p>	<p>No change for the final determination.</p> <p>We retain our overall approach to the assessment of financeability. We carry it out in our financial model, on the basis of the notional capital structure on which we derive our allowed return on capital and we assume each company is able to achieve the benchmarks in our determinations.</p> <p>Consistent with the PR19 methodology and our approach in the draft determination, we advance revenue from future customers where a financeability constraint</p>	We discuss our assessment of financeability in the 'Dŵr Cymru final determination' and the basis on which we consider Dŵr Cymru's final determination to be financeable on the basis of the notional capital structure.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			<p>credit rating, but it is unclear how this relates to the target thresholds set out in the response.</p> <p>The company has also stated that it has assessed actual financeability excluding post financeability adjustments. Whilst this is appropriate for the notional company to avoid diminishing the incentive regime, it does not reflect the reality faced by the company. However, Dŵr Cymru has set out this is not material.</p> <p>We expect Dŵr Cymru to provide further evidence to support the basis of its actual financeability assessment and additional Board assurance that the company is financially resilient as set out in action WSH.LR.C1.</p>		<p>arises to ensure the final determination is financeable on the basis of the notional capital structure.</p> <p>A number of companies and stakeholders have made similar representations in relation to providing Board assurance of the draft determination for the notional and/or actual capital structure.</p> <p>We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.</p>	
Risk and return	WSH.RR.A5	The company should ensure it is using the correct assumptions for the notional company in assessing the key financial ratios. The RPI rate of inflation should be used to translate the nominal cost of debt to real for index linked debt.	<p>No intervention required</p> <p>Dŵr Cymru has completed the action.</p>	No representation made.	No change for the final determination.	N/A
Risk and return	WSH.RR.A6	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.	<p>No intervention required.</p> <p>Dŵr Cymru's RCV run off rates are based on a range of estimates of average asset lives for assets within each wholesale control. The range of estimates is wide and the company provides little evidence to support the final rates chosen. However the company RCV run off rates are lower than the sector average and we accept Dŵr Cymru's RCV run off rates for the draft determination.</p>	<p>Representation made.</p> <p>The company provides representations that there is a requirement for an uplift of 0.23% to RCV run-off rates to address a notional financeability constraint.</p> <p>The company states the uplift is required to achieve levels for FFO/Net debt and RCV/Net debt in line with financeability within the sector draft determinations.</p>	<p>Change for the final determination.</p> <p>Following our assessment of financeability, we accept the company proposal to increase RCV run-off rates. We consider the resultant RCV run-off rates are within the acceptable range set out in the original business plan which was supported by sufficient evidence.</p> <p>The increase in RCV run-off rates has a beneficial impact on the funds from operations to net debt ratio and reduces the scope of the</p>	<p>We accept the company proposal to uplift RCV run-off rates by 0.23% across the water resources, water network plus and wastewater network plus controls in the final determination to address a financeability constraint. This brings forward £62 million of revenue.</p> <p>Following our assessment of financeability, we apply a further increase to RCV run-off rates of 0.16% to bring forward £41 million of revenue. We discuss</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
					<p>adjustments required to financial levels to improve notional financeability.</p> <p>Following the uplift, RCV run-off remains the second lowest in the sector. We consider the resultant average bills remain at a level supported by customers.</p>	our adjustments to advance revenue through PAYG and RCV run-off rates further in the 'Dŵr Cymru final determination'.
Risk and return	WSH.RR.C1	<p>Dŵr Cymru'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 Dŵr Cymru's stated approach.</p> <p>Dŵr Cymru has not updated its PAYG rates to reflect the changes it has made to operating and capital expenditure within totex in its revised business plan. Therefore, the PAYG rates are not consistent with the company's stated methodology.</p>	We are making a technical intervention to align PAYG rates to Dŵr Cymru's stated approach of recovering operating expenditure for each year for each wholesale control.	<p>Representation made.</p> <p>The company provides representations that the PAYG level within the draft determination did not appropriately reflect the high proportion of enhancement expenditure. The company has recalculated the levels of operating costs and infrastructure renewals expenditure.</p> <p>The company provides further representations that there is a requirement for an uplift of 1.7% to PAYG rates to address a notional financeability constraint in relation to the AICR ratio.</p>	<p>Change for the final determination.</p> <p>A number of companies and stakeholders have made similar representations in relation to the proportion of operating expenditure in cost allowances and the determination of PAYG rates.</p> <p>We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.</p>	<p>In order to calculate the mix of operating and capital expenditure we follow the approach set out in 'Securing cost efficiency technical appendix'. We set out our approach to assessing notional financeability and for addressing financeability constraints for the notional company for final determinations in the 'Aligning risk and return technical appendix'.</p> <p>Following our assessment of financeability, we do not consider the level of uplift to PAYG rates the company proposes is necessary to meet a notional financeability constraint. We bring forward revenue in Dŵr Cymru's final determination.</p> <p>We discuss our adjustments to advance revenue through PAYG and RCV run-off rates further in the 'Dŵr Cymru final determination'.</p>
Risk and return	WSH.RR.C2	Dŵr Cymru has not included any downside RoRE range for D-Mex & C-Mex in its assessment of financial risk factors for 2020-25.	The company should explain why it considers it appropriate to assess no downside risk range for D-Mex & C-Mex in its financial risk analysis, referring, where appropriate, to its historical performance under the SIM mechanism and in the C-Mex pilot study.	<p>Representation made.</p> <p>Dŵr Cymru says it has reconsidered its view of the upside and downside risk ranges for C-Mex following the draft determination in light of its performance in the C-Mex pilot study and historical SIM performance.</p>	<p>Change for the final determination.</p> <p>We apply a consistent approach to the presentation of the C-MeX and D-MeX risk ranges in our final determination for all companies on a notional basis.</p>	See WSH.RR.D4

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	WSH.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.	Representation made.  Dŵr Cymru provides updated App26 values for ODI risk ranges in its representation on the draft determination. The company considers that its risk range for ODIs is now heavily skewed to the downside.	Change for the final determination.	In our final determination for Dŵr Cymru we: <ul style="list-style-type: none"> <li>adjust the ODI rates for internal and external sewer flooding to be more in line with customer preferences and to provide a more balanced spread of incentives and risks;</li> <li>adjust the water supply interruptions 2024-25 level taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company and reduce the ODI underperformance rate to be symmetrical with the outperformance rate.</li> <li>make changes on mains repair to take account of historical levels of performance and the implications of leakage reduction levels for mains repairs;</li> <li>amend the deadband on the Compliance Risk Index, reducing the risk of underperformance payments in the last three years of 2020-25.</li> </ul> <p>Further information is provided in the 'Dŵr Cymru company specific appendix'.</p>
Risk and return	WSH.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	Representation made.  Dŵr Cymru provides updated App26 values for RoRE risk ranges in its representation on the draft determination.  We present our assessment of the RoRE risk range provided by the company in its representation in the	Change for the final determination.	See WSH.RR.D4.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			<p>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.</p>	<p>'Dŵr Cymru company specific appendix' which presents some downward skew to the overall risk range relating to totex risk and outcome delivery incentives.</p>		
Risk and return	WSH.RR.A1	The company should remove the uncertainty mechanism for business rates or provide compelling evidence to support the proposed uncertainty mechanism to support its view that adequate protections are not already in place given totex cost sharing arrangements. If the company retains an uncertainty mechanism in its revised business plan, it should ensure the proposal is underpinned by RoRE assessment in accordance with section 10.4.3 of the PR19 methodology.	No Intervention required.	No representation made.	Change for the final determination.	See WSH.RR.D4.
Risk and return	N/A	N/A	N/A	<p>Representation made.</p> <p>In its April plan, Dŵr Cymru proposes £76 million voluntary funding in support of its social tariff. This is over and above the cross subsidy provided by customers as customer research does not support an increase to the level of</p>	<p>Change for the final determination.</p> <p>The company's social tariff is the highest per capita across all of the water companies and is supported by the Welsh Government, the Consumer Council for Water and its customer support group. We accept</p>	<p>We accept the company approach and apply an increase of 0.21% to RCV run-off rates.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				<p>cross subsidy. In its representations, the company sets out that its voluntary contribution to social tariffs is achieved through revenue foregone, effectively reducing earnings. The company sets out that this, combined with the lower allowed return on capital represents a financial constraint for the notional company. The company proposes an increase to RCV run-off rates by 0.19% to bring forward £55 million to improve financial ratios and a commitment not to recover this amount of additional revenue.</p>	<p>the approach proposed by the company and apply an increase of 0.21% to RCV run-off rates. The company commits this revenue will not be collected and will be treated as revenue 'foregone'. We do not include the revenue foregone in our assessment of financial ratios for the financeability assessment and accept this adjustment as being in the interests of all of the company's customers over the long term. The increase in RCV run-off introduces a short term increase in the cross subsidy from customers but revenue foregone is effectively written off the RCV and therefore provides for lower bills for all customers in the longer term. We will ensure Dŵr Cymru fulfils its commitment to forego this revenue in 2020-25 through a bespoke adjustment to the retail revenue reconciliation at PR24. We will set out our approach to the reconciliation in the PR19 reconciliation rule book.</p>	
Securing confidence and assurance	WSH.CA.A2	<p>Acknowledging Dŵr Cymru is a company limited by guarantee, the company is required to confirm how it will adapt the expectations on dividends for 2020-25 for its circumstances as set out in 'Putting the sector in balance: position statement' to include:</p> <ul style="list-style-type: none"> <li>• clear board commitment to signal changes to its policy stakeholders; and</li> <li>• commitment to transparency that the dividend policy in 2020-25 will take account of obligations and commitments to customers applied in 2020-25 and when determining 'dividends'.</li> </ul> <p>Please provide an update on the steps you are taking to fully meet the</p>	<p>No intervention required but further action needed by the company.</p> <p>We expect Dŵr Cymru to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. The company should also confirm that it will publish statements on its dividend policy in its Annual Performance report. We expect the company to respond to these issues in its response to our draft determination.</p>	<p>Representation made.</p> <p>The company confirms that all dividend pay-outs for customers will be transparent and explained in detail in the context of how the dividend policy takes account of factors such as obligations and promises to customers and has detailed the specific obligations and commitments to customers that will be considered. The company has not confirmed that the level of performance delivery considered will be as set out in the final determination and provides insufficient detail on how performance delivery will impact on dividends paid.</p> <p>The company has not confirmed that it will publish statements on its dividend policy in its Annual Performance report.</p>	<p>Change for the final determination.</p> <p>We have updated our assessment of the reasonable base dividend for water companies in 2020-25 as set out in the 'Aligning risk and return technical appendix'</p> <p>Under our current assessment the company falls short in a number of areas set out below. We expect Dŵr Cymru to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25 and demonstrate how it has taken account of obligations and commitments to customers and other stakeholders, including;</p> <ul style="list-style-type: none"> <li>• how it has delivered against performance levels as set out in</li> </ul>	<p>Dŵr Cymru is a company limited by guarantee. It does not pay an equity dividend, however we expect the company to report transparently its performance through 2020-25 in its annual performance reports. We expect Dŵr Cymru to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25, to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		expectations as set out in our putting the sector in balance: position statement.			<p>the final determination and elsewhere, and</p> <ul style="list-style-type: none"> <li>how performance delivery has impacted on the dividends paid.</li> </ul> <p>We also expect the company to publish statements on its dividend policy in its Annual Performance Report.</p>	
Securing confidence and assurance	WSH.CA.A3	<p>On executive pay the company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance: position statement' to include:</p> <ul style="list-style-type: none"> <li>commitment to report how changes, including the underlying reasons, are signalled to customers; and</li> <li>commitment to publish the executive pay policy for 2020-25 once it has been finalised.</li> </ul> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance: position statement.</p>	<p>No intervention but further action needed by Dŵr Cymru.</p> <p>There remain some details to be finalised, for example details of the underlying metrics and associated weightings for both the annual and long term bonus schemes. Once finalised, we expect Dŵr Cymru to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance: position statement.'</p> <p>We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.</p>	<p>Representation made.</p> <p>In its response the company has provided some additional information to that previously provided, It confirms that targets will set by reference to the final determination, its business plan, past performance and comparative performance. It also states that the remuneration committee sets stretching annual targets for the annual bonus by reference to current and target performance and long term targets are likely to be stretching throughout the five year period.</p>	<p>Change for the final determination.</p> <p>Dŵr Cymru states that it is committed to meet the expectations set out in our 'Putting the sector in balance: position statement'. Based on our calculations, the overall percentage of alignment of incentives to customers is 100%, which we acknowledge as being sector leading and best practice compared to the 60% we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'.</p>	<p>We expect Dŵr Cymru to be transparent when explaining and reporting the application of its performance related executive pay policy over 2020-25, to demonstrate how it exhibits a substantial alignment to the delivery of service for customers and meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.			
Securing long-term resilience	WSH.LR.C1	The Board assurance on actual and notional financeability and financial resilience in the revised business plan was provided on the basis of the assumptions made in the business plan, prior to any interventions we have made in the draft determination and our updated view of the cost of capital. There is evidence of further downward pressure on the cost of capital in very recent market data which will be considered for our final determination.	We expect companies, in their responses to the draft determination, to provide further Board assurance that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including most recent data on the cost of capital.	<p>Representation made.</p> <p>Dŵr Cymru says that its board has carefully considered the draft determination and concluded that it is unable to provide assurance that the company would be financeable, primarily because it considers the WACC for the sector is too low. The company's board considers that the draft determination does not produce financial ratios that are adequate to secure the company's targeted BBB+/Baa1 credit rating and leaves no headroom to accommodate downside risks. The company notes that it has a significantly weaker set of key financial ratios (for the notional company) in the draft determination than any other company in the sector.</p> <p>The company's board also says that it is unable to provide assurance that a final determination would be financeable at an as yet unspecified, but potentially materially lower, level of WACC. The company consider that this could only be partially offset by further changes to financeability 'levers'.</p> <p>Dŵr Cymru says that its revised plan, submitted with its representation on the draft determination, is financeable, making use of the PAYG and RCV run-off rate 'levers' to deliver a package of financial ratios which, in the round, are on the margin of what is necessary to deliver the required credit rating for a notional company. The company says it is able to give assurance that its</p>	<p>No change for the final determination.</p> <p>We consider that our determinations are financeable for an efficient company with a notional capital structure. However, there is also a need for companies to ensure that they are financially resilient under their actual structures. We have not accepted all of the company's representations and the allowed return is lower in the final determination reflecting market expectations on the cost of finance. However, we note the allowed revenues in Dŵr Cymru's final determination are close to its business plan taking account of adjustments to maintain notional financeability and we consider our determination to be sufficient for an efficient company to meet its obligations and commitments to customers.</p>	<p>We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25 to test that adequate steps are being taken by management and that financial resilience is being maintained.</p> <p>In its future reporting, we expect the company to explain clearly in its long term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks.</p>

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				<p>representation plan is financeable and considers that target ratings (BBB+/Baa1) are achievable albeit with no margin of headroom. Dŵr Cymru says that it has reduced the dividend yield to zero to preserve financeability. It notes that there are significant implications for its continued ability to fund a proportion of its social tariff assistance.</p> <p>Dŵr Cymru has committed to assess its financial resilience beyond 2025 in its next long term viability statement.</p>		

**Table 2: Dŵr Cymru – Changes to the draft determination that are not in response to an action or representation**

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
Allowed return on capital	WSH.RR.D1	<p>We have revised our assessment of the allowed return drawing on market data up at 30 September 2019 and taking account of revisions to our approach following our assessment of representations.</p> <p>We have revised our assessment of the required retail margin deduction down from 0.11% to 0.04%, reflecting our view that the double-counted component of return in the household retail margin has reduced since PR14.</p> <p>We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.</p>	<p>The sector allowed return on capital for the appointee price controls in our final determinations is 2.96% – CPIH deflated (1.96% – RPI deflated), 23 basis points lower than in the draft determination.</p> <p>The sector allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated), 16 basis points lower than in the draft determination.</p>
Gearing outperformance sharing mechanism	WSH.RR.D2	<p>In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath.</p> <p>We explain this in the final determination 'Aligning risk and return technical appendix'.</p>	<p>We have changed the trigger from a fixed trigger of 70% in the draft determination to a glide path which will start at 74% for the year 2020-21 and will reduce by 1% each year, ending at 70% for the year 2024-25 in the final determination.</p>
Financeability	WSH.RR.D3	<p>We consider that Dŵr Cymru's final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.</p>	<p>We discuss our assessment of financeability in the 'Dŵr Cymru final determination' and the basis on which we consider Dŵr Cymru's final determination to be financeable on the basis of the notional capital structure.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	WSH.RR.D4	<p>We have revised our approach to assessing RoRE risk ranges for five of the risk areas set out in the PR19 methodology to take account of changes we have made in our final determinations to address concerns raised by companies on the overall level of stretch in our draft determinations, and evidence on past performance that we have observed in the sector.</p> <p>Our approaches are set out in the 'Aligning risk and return technical appendix' and the risk ranges for Dŵr Cymru are set out in the 'Dŵr Cymru's final determination'.</p> <p>Taking account of changes in our final determination, the RoRE risk ranges at P10 and P90 confidence limits in our final determinations are, in most cases, more symmetrical than the risk ranges represented by companies. Our view of risk ranges also indicates more scope for outperforming companies to earn higher returns, but also for underperforming companies to receive lower returns.</p>	<p>The final determination risk range reflects the following interventions that we make for all companies:</p> <ul style="list-style-type: none"> <li>• The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination.</li> <li>• The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt.</li> <li>• The ODI risk range has been determined under our Outcomes Framework.</li> <li>• The C-MeX risk range is calculated as 12% upside and 12% downside of residential retail revenue, reflecting the cap and collar limits for this incentive.</li> <li>• The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.</li> </ul>
Financial Risk Assessment – Uncertainty Mechanisms	WSH.RR.D5	<p>We are including a PR24 reconciliation mechanism for business rates in our final determination for Dŵr Cymru along with all other companies because:</p> <ul style="list-style-type: none"> <li>• There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material.</li> </ul>	<p>In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst receiving appropriate protection against material cost increases. Conversely, customers will receive a benefit if outturn costs are lower</p>

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
		<ul style="list-style-type: none"> <li>• Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices.</li> </ul> <p>We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for Dŵr Cymru along with all other companies serving England because:</p> <ul style="list-style-type: none"> <li>• The Environment Agency expects to consult on changes to its basis for setting abstraction licence fees during 2020 meaning that there is material uncertainty about company cost levels in 2020-25.</li> <li>• Companies can only exercise limited control over cost levels by engaging with the consultation process and providing accurate information when required for licence fee setting purposes.</li> </ul>	<p>than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	WSH.RR.D6	Dŵr Cymru considers that it has a downward risk skew in relation to its retail activity costs. It attributes this to risks that bad debt levels might be higher than assumed, and expected savings on customer contact costs might not be achieved.	We understand Dŵr Cymru's expected downside skew in respect of retail activity costs relates to a reducing bad debt provision for 2020-25. However, we do not consider that it has provided sufficient evidence to justify a downward skew to its risk range, and we consider there remains scope for Dŵr Cymru to outperform its retail cost allowances and so we have revised the upside risk range to be symmetrical with the downside risk range.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gov.uk](mailto:mailbox@ofwat.gov.uk)

December 2019

© Crown copyright 2019

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit [nationalarchives.gov.uk/doc/open-government-licence/version/3](http://nationalarchives.gov.uk/doc/open-government-licence/version/3).

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk).

Any enquiries regarding this publication should be sent to us at [mailbox@ofwat.gov.uk](mailto:mailbox@ofwat.gov.uk).

