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PR19 final determinations

South Staffs Water – Aligning risk and return final decisions

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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 'SSC' denotes the company South Staffs Water. 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 South Staffs Water draft determination, please see the final determinations webpage.

Table 1: South Staffs Water – 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	SSC.RR.A1	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.	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.	No representation made.	No change for the final determination.	N/A
Risk and return	SSC.RR.A2	The company should revise its assessment of revenue risk in its RoRE analysis, or provide convincing	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
		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.	South Staffs Water has satisfactorily responded to this requirement.			
Risk and return	SSC.RR.B1	The company should provide a clearer link between its internal risk management and mitigation procedures and its RoRE analysis.	No intervention required. The company has provided a satisfactory response to this requirement.	No representation made.	No change for the final determination.	N/A
Risk and return	SSC.RR.A3	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.	Intervention required. 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. 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. 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	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
			provide a bill profile consistent with customer preferences. 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. 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.			
Risk and return	SSC.RR.A4	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.	Intervention required. 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. 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	Representation made. The company states that it has concerns with the financeability assessment within the draft determination due to: • Allowed totex profile • Use of incorrect natural PAYG rates In period outcome delivery incentive payments.	Change from the draft determination. 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. South Staffs Water suggests the financeability assessment should take account of in-period outcome delivery incentive penalties. It sets out a significant skew towards a penalty position and that its financeability assessment is impaired by our assessment of its claim for the wholesale forecasting revenue incentive mechanism. We maintain our position that the financeability	Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions. 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 how we apply the technical intervention in the 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our determinations.

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			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. 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. 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.		assessment should be carried out on the basis of an efficient company that meets its performance commitments – we consider that resolving a financeability constraint on the basis of a downside scenario would not adequately protect the customer interest. We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.	
Risk and return	SSC.RR.A5	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.	Intervention required. 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 is has carried out further modelling for the period 2025-30 and that this ratio is above 1.5x for each of the years modelled, but does not provide the actual ratios. The financial ratios are consistent with the target credit rating for the actual structure. However, the ratios are calculated based on PAYG rates	No representation made.	Change for the final determination. Following our assessment of financeability we are advancing revenue through the use of PAYG rates to align the financial ratios targeted by the company on a notional basis. 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.	Following our assessment of financeability we are advancing revenue through the use of PAYG rates to align the financial ratios targeted by the company on a notional basis. We increase PAYG rates by 2.12% to bring forward £18.8m and increase RCV run-off rates by 0.72% to bring forward £24.5m of allowed revenue from future periods. We discuss our assessment of financeability in the 'South Staffs Water final determination' and the basis on which we consider South Staffs Water'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
			including the proposed adjustment to address the notional financeability constraint identified by the company. 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, 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. 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.		Consistent with the PR19 methodology and our approach in the draft determination, we advance revenue from future customers where a financeability constraint arises to ensure the final determination is financeable on the basis of the notional capital structure.	
Risk and return	SSC.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.	No intervention required. South Staffs Water has provided sufficient evidence of the approach and calculation of its RCV run-off rates.	No representation made.	No change for the final determination.	N/A
Risk and return	SSC.RR.C1/C4	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 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	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. 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. In its representation on the draft determination, South Staffs Water says that our interventions have resulted in a package that is in significant penalty at both the P50 and P90 scenarios and not aligned to Ofwat's original methodology intentions, where a RORE range of +1% to +3% for the P90 level of performance was indicated. South Staffs Water says this demonstrates it is substantially	Change for the final determination.	See SSC.RR.D5 Our approach to the risk ranges for a company with a notional structure are set out in the 'Aligning risk and return technical appendix'. We comment on the overall level of stretch in our determinations in an annex to the 'Securing cost efficiency technical appendix'

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		take account of covariance in performance on individual outcome delivery incentives.		outside of the expected range and warrants appropriate intervention. The company provides an updated view of ODI risk ranges using Monte Carlo simulation.		
Risk and return	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.	Representation made. The company provides representations that the reduction in totex allowance should be allocated mainly, if not entirely, to capex.	Change for the final determination. 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. We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.	Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions. 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'. We set out the specific interventions we make for South Staffs Water in relation to notional financeability in the 'South Staffs Water final determination' document.
Risk and return	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 'Aligning risk and return technical appendix', we are considering the assessment of debt cost risk further for the final determination.	No representation made.	Change for the final determination.	See SSC.RR.D5.

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Risk and return	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.	Representation made. South Staffs Water provides updated views on RoRE risk ranges in its representation. The company expresses concern that there is inconsistency of approach to RoRE risk analysis for ODIs between companies. We present our assessment of the RoRE risk range provided by the company in its representation in the 'South Staffs Water company specific appendix' which presents a slight downward skew to the overall risk range relating to totex risk and outcome delivery incentives.	Change for the final determination.	See SSC.RR.D5
Risk and return	N/A	N/A	N/A	Representation made. The company provides representations that the draft determination is not financeable under either the notional or actual structure. The company states that Ofwat's approach of not taking the £15 million developer services revenue adjustment into account when assessing the financeability artificially improves the financial metrics.	No change for the final determination. 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.	We discuss our assessment of financeability in the 'South Staffs Water final determination' and the basis on which we consider South Staffs Water'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
				The company states that the plan would be financeable if the plan including the key representations as set out in this document are accepted by Ofwat.	Consistent with the PR19 methodology and our approach in the draft determination, we advance revenue from future customers where a financeability constraint arises to ensure the final determination is financeable on the basis of the notional capital structure.	
Risk and return	N/A	N/A	N/A	Representation made. The company provides representations that it proposes to use its covenanted gearing rather than the regulatory gearing reporting in the annual performance report. The company states its definition of gearing reflects the true liability of the company and that by using the regulatory gearing, it will affect its current credit rating with Moody's.	No change for the final determination. The company's definition of gearing is specific to its own financing arrangements and is a matter for the company and its investors. South Staffs already publishes its own definition of gearing in its annual performance report, therefore we conclude our use of regulatory gearing would not affect rating agencies' view in this instance. Overall, we consider that the company has not provided sufficient evidence that its proposed alternative mechanism would deliver equivalent benefits for customers in the round.	We set out our approach to the company proposal in the 'Aligning risk and return technical appendix'.
Securing confidence and assurance	SSC.CA.A1	On gearing benefits sharing the company forecasts gearing above 70% in 2024-25; it should incorporate our default sharing mechanism from our 'Putting the sector in balance' position statement into its plan so that customers will receive bill reductions if gearing in any year is above the 70% threshold. It should provide convincing evidence to explain why its view that covenanted gearing rather than gearing defined in the regulatory accounting guidelines is the most appropriate measure for the mechanism, taking account of the interests of customers.	The intervention we made at the draft determination, we expect South Staffs Water to apply our default benefit sharing mechanism. If the company does not apply the default mechanism set out in the 'Putting the sector in balance' position statement, we intend to make an adjustment at PR24 to ensure benefits are adequately shared with customers.	Representation made. South Staffs Water restate its view presented in its April 2019 revised business plan that it will adopt the default mechanism as set out our 'Putting the sector in balance' position statement, but considers it should be use its definition of covenant gearing rather than regulatory gearing. The company state that its investors, lenders and rating agencies use covenant debt rather than book debt when assessing its gearing. The company explains that if it were to use book debt, this would lead to a higher reported level of gearing, which could impact its credit rating. This	Change for the final determination. We do not consider that South Staffs Water's mechanism, with its bespoke definition of gearing, provides benefits that are equivalent, in the round, to our default sharing mechanism. We consider South Staffs Water's definition for gearing is specific to its own financing arrangements and is a matter for the company and its investors. Their definition is inconsistent with the definition of gearing in the Regulatory Accounting Guidelines (RAGs). South Staffs Water has not provided convincing evidence that its proposed alternative	We apply our revised mechanism which introduces a glide path as described in the 'Aligning risk and return technical appendix' for the final 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
				leading to new debt being more expensive to raise, which is not in the interest of customers. The company considers that covenant net debt reflects the actual liability of the company to its lenders.	mechanism would deliver equivalent benefits for customers in the round. South Staffs already publishes its own definition of gearing in its annual performance report, therefore we concluded our use of the standard definition of regulatory gearing would not affect rating agencies decision and cost of debt in this instance.	
Securing confidence and assurance	SSC.CA.A2	On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' to include: • clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and • commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends. 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.	No intervention but further action needed by South Staffs Water. We expect South Staffs Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the expectations we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination. We expect the company 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. In doing so, the company should refer to the examples of best practice we have identified among companies.	Representation made. The company provided some additional information in response to our action. The company has set out how its dividend policy for 2020-25 will take account of obligations and commitments to customers and other stakeholders, and provides sufficient detail on the specific obligations and commitments to customers that will be considered, The company has confirmed that the performance levels considered relevant under the dividend policy are the final determination performance commitments. The company confirms that dividends can be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid.	Change for the final determination. 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'.	We expect South Staffordshire Water 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'.
Securing confidence and assurance	SSC.CA.A3	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' to include: • commitment to report how changes, including the underlying reasons, are signalled to customers; and	No intervention but further action needed by South Staffs Water. There remain some details to be finalised, for example details of the underlying metrics and associated weightings, and confirmation as to whether the company will have a single scheme or an annual and long term scheme. Once finalised, we	Representation made. In its response the company has provided some additional information to that previously provided. It states that during 2020-25, it will operate both an annual and long-term incentive scheme. The annual bonus consists of:	Change for the final determination. South Staffs Water 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 higher than the 60% we highlighted as evidence of good	We expect South Staffs Water 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

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
		• commitment to publish the executive pay policy for 2020-25 once it has been finalised. 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.	expect South Staffs Water 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.' 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. 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.	1/3 financial objectives (profit, cash generation, totes and cost efficiency) 1/3 customer service objectives (C-Mex, D-Mex and complaints) 1/3 performance arising from the standard outcomes for the sector (leakage, supply interruptions, CRI, PCC, mains bursts, unplanned outages and employee safety) The long term incentive scheme is still being designed but will be completed before the start of AMP7, and that most potential payments will be based on performance delivery for customers. Initially, for both schemes, target will be set against the final determination outcomes. During 2020-25 the remuneration committee will monitor the level of stretch contained within the targets with reference to the upper quartile level for the sector. Targets will be modified as necessary during the period to ensure they remain appropriate and challenging.	practice amongst the companies we regulate in our document, PR19 draft determinations: Aligning risk and return technical appendix. .	balance' as updated in 'Aligning risk and return technical appendix'.
Securing confidence and assurance	SSC.CA.A7	The company should explain the assurance process it has taken to develop its tax forecasts to demonstrate that amounts proposed for tax take account of customer interests, in particular to clarify the scope of the assurance work that was undertaken and the outcome of that work. The company's appointee WACC is 0.01% higher than our 'early view'. It should alter its business plan table	No intervention required for the Draft Determination but further action needed by South Staffs Water. South Staffs Water is required to provide further evidence to explain the scope of the third party review that was undertaken on its tax forecasts and the outcome of the work. Should the company not provide sufficient evidence in advance of the Final Determination, we will consider	Representation made. In its response the company set out that it took a proportionate approach to the assurance of its tax computations. The overall tax allowance in its April submission was £3.0 million over the period, equating to less than £1 on customer bills. South Staffs Water did not provide any evidence of assurance as no formal engagement was undertaken.	No change for the final determination. For South Staffs Water, whilst the company has not provided sufficient evidence to demonstrate that its approach to assurance was reasonable, on the grounds of materiality of the tax allowance we take no further action for the final determination. We are currently developing our approach to the assurance of data and information for the next price	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
		inputs to derive the required 5.47% nominal figure.	whether it is appropriate to make an adjustment to the tax allowance in the Final Determination to reflect this.		control period and will provide more details in early 2020.	
Securing long-term resilience	SSC.LR.A4	The company sets out that it targets a credit rating of Baa1. However the company's financial ratios decline through 2020-25. The company expects its financial ratios to improve in 2025-30 based on its assumption of the continuation of the 'early view' cost of capital through 2025-30; though it notes a risk that the cost of capital could be lower in 2025-30. While the company proposes a small reduction in gearing through 2020-25, it shows limited headroom in its financial ratios through 2020-25, which provide the company with limited headroom against any cost shocks. We seek further Board assurance from the company that the targeted gearing level and credit rating for its actual financial structure are consistent with maintaining financial resilience in the long term, with reference also to action SSC.LR.C1. In its future reporting, we expect South Staffs Water to apply suitably robust stress tests in its long term viability statements in 2020-25.	N/A	Representation made. The board considers that, if its representations are accepted, then based on the financial projections, the stress tests performed and the mitigations available, in its opinion, the company will remain financeable on both an actual and notional basis The company's board also confirms that the targeted gearing level and credit rating for the company's actual structure would be consistent with maintaining financial resilience over the long term. It says this is based on the financial metrics set out in its draft determination representations being consistent with the company's target credit rating of Baa1 for Moody's and BBB+ for S&P. It refers in particular to the repayment of a £15 million inter-company loan providing more headroom in the company's gearing against cost shocks. The board assurance statement does say that if there is any significant further reduction in the cost of capital, it may not allow the company to maintain further financial resilience and further intervention may be required. South Staffs Water has committed to assess its financial resilience beyond 2025 in its next long term viability statement.	No change for the final determination. 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 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. Therefore, on account of South Staffs Water's gearing which is above the notional level, the cost of capital in our final determinations that is lower than the draft determinations and the available headroom in its credit ratings, the company may need to take steps to maintain its financial resilience in 2020-25.	South Staffs Water may need to take further steps to improve its financial resilience. 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. 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.
Securing long-term resilience	SSC.LR.A5	The company should carry out an assessment of its financial resilience for the period beyond 2025, highlighting the key challenges that the company might face and how it	See actions SSC.LR.A4 and SSC.LR.C1.	As per SSC.LR.A4	See SSC.LR.A4.	See SSC.LR.A4.

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
		intends to manage and mitigate these.				
Securing long-term resilience	SSC.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 to provide further Board assurance, in their responses to the draft determination, 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 evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Allowed return on capital technical appendix'.	See SSC.LR.A4.	See SSC.LR.A4.	See SSC.LR.A4.

Table 2: South Staffs Water – 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	SSC.RR.D1	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. 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. We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.	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. 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.
Allowed return on capital	SSC.RR.D2	South Staffs Water has applied for a Company-Specific Adjustment (CSA) to the allowed return on capital. We have assessed its application using our three-stage approach as set out in our PR19 final methodology. Taking account of updated information in the final determination and in representations, we consider that the company have passed all three stages. We provide further detail on these issues in our 'Allowed return on capital technical appendix'.	We have allowed an uplift to the sector allowed return on debt of 33 basis points, equating to an allowed return on capital for the water resources and water network plus controls of 3.11% (on a CPIH basis, 2.11% on a RPI basis).
Gearing outperformance sharing mechanism	SSC.RR.D3	In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return technical appendix'.	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.
Financeability	SSC.RR.D4	We consider that South Staffs Water'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.	We discuss our assessment of financeability in the 'South Staffs Water final determination' and the basis on which we consider South Staffs Water's final determination to be financeable on the basis of the notional capital structure.
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	SSC.RR.D5	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. Our approaches are set out in the 'Aligning risk and return technical appendix' and the risk ranges for South Staffs Water are set out in the 'South Staffs Water final determination'. 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.	The final determination risk range reflects the following interventions that we make for all companies: • 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. • The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt. • The ODI risk range has been determined under our Outcomes Framework. • 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.

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
			• 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.
Financial Risk Assessment – Uncertainty Mechanisms	SSC.RR.D6	We are including a PR24 reconciliation mechanism for business rates in our final determination for South Staffs Water along with all other companies because: • 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. • 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. We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for South Staffs Water along with all other companies serving England because: • 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. • 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.	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 than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.

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

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