

December 2019

PR19 final determinations

South West 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 ‘SWB’ denotes the company South West 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 West Water draft determination, please see the [final determinations webpage](#).

Table 1: South West 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	SWB.RR.C1	South West Water’s approach to PAYG rates is to recover in each year an amount equivalent to operating costs and similar expenses, plus infrastructure renewal costs. The Ofwat view of totex has a different profile of operating and capital expenditure. Using the company’s PAYG rates would result in PAYG revenue not being consistent with the approach stated in the business plan.	We are intervening to amend the PAYG rates across all wholesale controls to reflect the mix of operating and capital expenditure in our view of efficient costs in the draft determination. The changes maintain the company’s stated approach for PAYG of recovering operating costs and similar expenses plus infrastructure renewal costs.	Representation made. The company states that it is making a number of representations relating to both base and enhanced expenditure to support the original business plan submission. The company would therefore expect the split of Opex and Capex to be consistent with this.	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 and efficiency technical appendix’. We set out our approach to assessing notional financeability and for

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						<p>addressing financeability constraints for the notional company for final determinations in the 'Aligning risk and return technical appendix'.</p> <p>We set out the specific interventions we make for South West Water in relation to notional financeability in the 'South West Water final determination' document.</p>
Risk and return	SWB.RR.C2	In our draft determination summary, we note that the RoRE risk ranges shown in Table 5.1 and Figure 5.1 reflect our interventions and, in particular, that we have included the RoRE risk ranges for ODIs shown in Table 2.3 of the summary document.	The company should provide an updated view of RoRE risk ranges at P10/P90 confidence levels in light of our draft determination. For this purpose, the company should apply its view on the interactions between individual ODI risks in arriving at an overall risk range for ODIs. Calculations should be carried out using the App26 rows on the F-Inputs tab of the draft determination financial model with values read off the model dashboard. The company's updated view should be provided in its response to the draft determination.	<p>Representation made.</p> <p>South West Water provides updated RoRE risk range views in its representation on the draft determinations.</p>	Change for the final determination.	See SWB.RR.D4.
Risk and return	N/A	N/A	N/A	<p>Representation made.</p> <p>The company states that in line with the company representation provided for the fast track draft determinations, the company seeks to reflect dividends consistent with the returns allowed within revenue to ensure that the gearing levels at a notional level are more aligned with the PR19 methodology.</p>	Change for the final determination.	<p>We revise our notional dividend yield to 3.00% (from 3.16% in the fast track draft determination) and apply a dividend growth of 1.18% (1.36% in the fast track determination) in our notional financeability assessment for South West Water. This takes account of the allowed cost of equity in the final determination.</p> <p>We discuss our policy approach to the notional dividend yield assumption in final</p>

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						<p>determinations in the 'Aligning risk and return technical appendix'.</p> <p>We have revised our guidance for the reasonable base dividend yield for a company with little real RCV growth and that performs in line with our determination in 2020-25. We explain this in the 'Aligning risk and return technical appendix'.</p>
Securing confidence and assurance	SWB.CA.A2	<p>On dividend policy the company should 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:</p> <p>Clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders.</p> <p>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.</p> <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>Intervention required.</p> <p>We look to South West Water to provide a clear 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. We expect the company to provide an update on these issues in response to our draft determination.</p>	<p>Representation made.</p> <p>In its response to the draft determination and subsequent query response the company has provided some additional information to that previously provided. The company confirms that the outturn dividend yield would depend on whether the company has delivered on its commitments to customers, but provides insufficient detail on the specific obligations and commitments to customers that will be considered.</p> <p>The company confirms that the level of performance delivery considered will be as set out in the final determination. The company also 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.</p>	<p>Change for the final determination.</p> <p>We have updated our assessment of the reasonable base dividend for water companies in 2020-2025 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 South West Water 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 detail on the specific obligations and commitments considered under the policy.</p>	<p>We expect South West 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'.</p>
Securing confidence and assurance	SWB.CA.A3	<p>On executive pay, the company should 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:</p> <ul style="list-style-type: none"> Providing full details and commitment to publish, including 	<p>No Intervention required.</p> <p>We understand that there remain a number of details to be finalised, for example how targets are to be set and to demonstrate how they will deliver stretching performance for customers through 2020-25.</p>	<p>No representation made.</p> <p>The company has provided no additional information in its response to its own draft determination or in its response to the slow track and significant security draft determinations.</p>	<p>Change for the final determination.</p> <p>South West 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 in line with the 60%</p>	<p>We expect South West 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</p>

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		<p>all performance metrics, the executive pay policy for 2020-25</p> <ul style="list-style-type: none"> • Visibility and evidence of substantial linkage of executive remuneration to delivery to customers • Clear explanation of stretching targets and how they will be applied. • Clear explanation of how the policy will be rigorously applied and monitored. • Commitment to report how changes, including the underlying reasons, are signalled to customers. <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>We expect the company and its remuneration committee to ensure executives continue to have stretching targets linked to performance delivery for customers. We expect the company to be transparent about further updates to the development of its policy that will apply in 2020-25.</p>		<p>we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'. However we consider that there is scope for the company to improve this position.</p>	<p>set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>
Securing confidence and assurance	SWB.CA.A5	<p>WaterShare. The company should publish information that explains the following elements of WaterShare:</p> <ul style="list-style-type: none"> • its governance and decision-making arrangements; and • how it will calculate any amount to be shared (including the stated £20 million outperformance sharing on the cost of embedded debt) and report its annual decisions. 	<p>Intervention required.</p> <p>South West Water should, in its response to its draft determination, set out how it will allocate sharing payments (including the role of customer preferences) and how it will report the amounts distributed. Its business plan submissions only explain how its governance process works for the current control period.</p>	No representation made.	N/A	N/A

Table 2: South West 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	SWB.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	SWB.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	SWB.RR.D3	<p>We consider that South West 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.</p>	<p>We discuss our assessment of financeability in the 'South West Water final determination' and the basis on which we consider South West Water's final determination to be financeable on the basis of the notional capital structure.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	SWB.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 South West Water are set out in the 'South West Water 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"> • 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. • 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		<p>We are including a PR24 reconciliation mechanism for business rates in our final determination for South West Water along with all other companies because:</p> <ul style="list-style-type: none"> • 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. 	<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>

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		<ul style="list-style-type: none"> • 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. <p>We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for South West Water along with all other companies serving England because:</p> <ul style="list-style-type: none"> • 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. 	<p>than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.</p>

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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