

December 2019

# PR19 final determinations

**Southern Water – Aligning risk and return  
final decisions**

**o f w a t**

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

## PR19 final determinations: Southern Water – 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 ‘SRN’ denotes the company Southern 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 Southern Water draft determination, please see the [final determinations webpage](#).

**Table 1: Southern 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	SRN.RR.A1	The company targeted a credit rating for the notional company with that is one notch above a 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 actions that could be taken to secure the long term financeability of the notional company.	No intervention required.  The Board has provided assurance that it has targeted a credit rating of Baa1 on a notional basis. Our PR19 methodology notes that different credit rating agencies adopt different approaches to their credit rating assessment, however we retain the view that cashflows brought forward by PAYG adjustments can help to mitigate a financeability constraint so long RCV is not depleted and the	Representation made.  The company provides representations that the draft determination is financeable at Baa2 on the basis of the notional and actual structures.  It considers Baa2 to be a more appropriate target due to the draft determination WACC and the exclusion	No change for the final determination.  We set out our assessment in the ‘Aligning risk and return technical appendix’. We take account of the key financial metrics targeted by each company and therefore may place more emphasis on the level of adjusted interest cover or funds from operations to net debt in our assessment of financeability of the notional capital structure for that company. We note that all	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
			bring forward of revenue is supported by customer preferences.	of fast money on the basis of credit rating agency methodologies.	companies, in their April business plans stated a target credit rating that was a minimum 2 notches above the minimum of investment grade (BBB+/Baa1/BBB+ Fitch, Moody's, Standard and Poor's). We do not specify an appropriate credit rating for the notional capital structure. However, taking account of companies' targets, we use two notches above the minimum investment grade as the basis for our assessment of financeability.	
Risk and return	SRN.RR.A2	The company should provide further evidence to support the calculation of PAYG rates and demonstrate that the rates are consistent with the approach set out in the business plan.	<p>Intervention required.</p> <p>Southern Water has provided insufficient evidence to complete the action.</p> <p>The company has provided further evidence to support its approach to PAYG rates including in response to a further query on this issue.</p> <p>The company has allocated reactive renewals, IT expenditure relating to maintaining corporate systems and expenditure related to studies, investigations and inspections not specifically related to the location and construction of a new project to PAYG. This approach, along with RCV run-off rates which are relatively high in comparison with the rest of the sector, results in the company recovering a higher proportion of capital expenditure in the price review period than other companies.</p> <p>However, it is not clear why only current customers should pay for all costs required to maintain the operating capability of the company</p>	<p>Representation made.</p> <p>The company accepts the intervention.</p> <p>The company does provide representations that the draft determination includes an incorrect split of opex and capex used to set the PAYG rates.</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>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.</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 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.</p> <p>We discuss our assessment of financeability in the 'Southern Water final determination' and the basis on which we consider Southern Water's final determination to be financeable on the basis of the notional capital structure.</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>when future customers may also benefit from the expenditure.</p> <p>We are intervening to reduce PAYG rates by an average of 5.7% to align with our view of operating expenses and infrastructure renewal expenses as a proportion of totex in the draft determination</p> <p>This reduces revenue in the period by £182m.</p> <p>As a consequence of our PAYG intervention we have not needed to make the technical intervention to PAYG rates as we have aligned these directly to our view of totex.</p>			
Risk and return	SRN.RR.A3	The company should set out how the approach to setting RCV run-off rates reflects the underlying RCV for the company for each wholesale control and provide more evidence to demonstrate that the rates are consistent with the company's approach.	<p>No intervention required.</p> <p>Southern Water has provided further evidence in relation to its RCV run-off rates however, there is insufficient convincing evidence that the RCV run-off rates are appropriate.</p> <p>In response to a query, Southern Water provided further evidence to support the calculation of RCV run-off rates and the impact of the PAYG approach to average asset lives. The average asset life in the resubmitted business plan is calculated as 19.5 years and in the response to the query as 28.4 years for non-PAYG assets. We remain concerned that the calculation of average asset lives is not consistent with the approach to PAYG rates.</p> <p>We consider our assessment of financeability in the round, and therefore have not intervened on RCV run-off when combined with the substantial intervention we have made to PAYG rates as per action SRN.RR.A2.</p>	<p>Representation made.</p> <p>The company accepts our intervention as per action SRN.RR.A2.</p>	No change from the draft 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	SRN.RR.A4	The company should provide further evidence that the level of the proposed adjustments to RCV run-off rates do not result in overall revenue being transferred between price review periods and are supported by customer preferences.	No intervention required.  As per SRN.RR.A3. The company provides sufficient evidence and sets out that the adjustments are to balance the change to bills for water and wastewater customers and provides sufficient evidence that this does not move revenue between price review periods.	No representation made.	No change for the final determination.	N/A
Risk and return	SRN.RR.A5	The company should check that the base RoRE value of 3.8% shown in the business plan has been calculated correctly and amend/re-present if necessary.	No intervention required.  The company has provided sufficient evidence to complete the action for the purposes of its RoRE presentation in the revised business plan.	No representation made.	No change for the final determination.	N/A
Risk and return	SRN.RR.A6	The company should amend its overall assessment of RORE outcomes, or provide convincing evidence to explain why it is reasonable to assume totex outcomes should be asymmetrically skewed to the downside for a notional company within an incentive based regime.	No intervention required.  The company presents a totex RoRE range of -1.28% to +1.11% which is broadly symmetric. We consider that efficient companies should be able to achieve the base equity return on the notional structure; however it is not unreasonable for inefficient companies to forecast greater scope for underperformance. We address these issues further in the 'Aligning risk and return technical appendix'	No representation made.	No change for the final determination.	N/A
Risk and return	SRN.RR.B1	Acknowledging the explanatory material that the company has provided on its assessment of P10/P90 values for RoRE risk scenarios, and that values have been presented on a post-mitigation basis, please provide views on why Southern's risk ranges are relatively low, compared to the majority of companies.	Southern Water says that its outcome delivery incentive upside range is limited by the findings of its customer research.  It has also updated its totex ranges to indicate more upside potential, but it still considers that its analysis presents a fair view of the risks it faces.	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
			<p>The company considers that the probability of all the individual P10/P90 RORE ranges occurring simultaneously would be significantly lower than the probability of an individual P10/90 risk materialising.</p> <p>The company considers its approach to combining multiple low probability but significant events accounts for an apparently lower RoRE range, rather than large inherent differences in risks.</p>			
Risk and return	N/A	N/A	N/A	<p>Representation made.</p> <p>The company provides representations that the both the FFO/Net Debt and AICR ratios are calculated including the revenue from the pension deficit recovery costs (PDRC) The company states that credit rating agencies do not include this value as a cost which therefore assumes an artificial uplift to these ratios within the draft determination.</p> <p>The company states this should be corrected for the final determinations.</p>	<p>Change for the final determination.</p> <p>We consider the reparation of pension deficits over and above the allowance is a matter for companies and their shareholders. Our approach is to exclude these costs from our assessment of financeability to protect customers from the potential impact of this.</p> <p>For the final determination, we are not changing the principle of the adjustment however we note our approach for the draft determination also removed costs which are funded through allowed revenue. For the final determination, we match the pension deficit recovery costs to the revenue allowance in our assessment of notional financeability.</p>	<p>A number of companies and stakeholders have made similar representations in relation to the inclusion of revenue from the pension deficit recovery charges. We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.</p>
Risk and return	N/A	N/A	N/A	<p>Representation made.</p> <p>The company provides representations that the approach taken by Ofwat to the calculation key financial ratios departs from the approach adopted in the market by credit rating agencies which undermines the robustness of the financeability assessment.</p>	<p>No change for the final determination.</p> <p>A number of companies and stakeholders have made similar representations in relation to financeability of the notional company.</p>	<p>As set out in the PR19 methodology and the 'Aligning risk and return technical appendix', each credit rating agency adopts a slightly different approach to the calculation and definition of key financial ratios. We do not therefore follow the precise approach of any credit rating agency.</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>The company states that within its Licence a company should maintain an investment grade credit rating. However, Ofwat does not reflect or consider the widely recognised and independent methodologies of the credit rating agencies within the financeability assessment for the price review.</p>	<p>We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.</p>	<p>We set out our approach to assessing notional financeability for final determinations in the 'Aligning risk and return technical appendix'.</p> <p>We set out the specific interventions we make for Southern Water in relation to notional financeability in the 'Northumbrian Water final determination' document.</p>
<p>Securing confidence and assurance</p>	<p>SRN.CA.A4</p>	<p>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: position statement' to include:</p> <ul style="list-style-type: none"> <li>• clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and</li> <li>• 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.</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 Southern Water.</p> <p>We expect Southern 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 factors we set out in our putting the sector in balance: position statement and we expect the company to be clear about how it will take account of the particular risks to its long term financial resilience, set out in the securing long-term resilience actions and interventions tracker. We expect the company to respond to this issue in its response to our draft determination.</p> <p>We expect Southern Water 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.</p>	<p>Representation made.</p> <p>The company provides some additional information in response to our action.</p> <p>The company sets out how its dividend policy for 2020-25 will take account of obligations and commitments to customers and other stakeholder but it provides insufficient detail on the specific obligations and commitments to customers that will be considered. In subsequent correspondence the company confirms that the level of performance delivery considered will, subject to any redetermination by the CMA in the event of an appeal, be the final determination.</p> <p>The company has also provided further information on how performance delivery will impact on dividends paid, confirming that dividends may be either increased or lowered from the base depending on the actual performance of the company.</p> <p>We address the company's response in relation to how it will take account of particular risks to its long term financial resilience in the securing long-term resilience decisions document.</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 Southern 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 Southern 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>

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
Securing confidence and assurance	SRN.CA.A5	<p>On executive pay the company is required to confirm that it 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>visibility and evidence of substantial linkage of executive remuneration to delivery to customers;</li> <li>clear explanation of stretching targets and how they will be applied;</li> <li>clearer explanation of how the policy will be rigorously applied and monitored;</li> <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 Southern Water.</p> <p>There remain some details to be finalised, for example the finalisation of the policy for 2020-25 including details of the underlying metrics and associated weightings and how the long term policy demonstrates a substantial alignment to the interests of customers. Once finalised, we expect Southern 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: 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>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.</p>	<p>No representation made.</p> <p>The company has provided no additional information in its response, however it states that its process and remuneration committee meeting dates are aligned to the final determination, and it will submit to Ofwat its final proposed metrics once the remuneration committee has met following the receipt of its final determination.</p>	<p>Change for the final determination.</p> <p>Southern 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 practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'.</p>	<p>We expect Southern 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 balance' as updated in 'Aligning risk and return technical appendix'.</p>
Securing long-term resilience	SRN.LR.A3 (and related actions A4 – A8)	<p>We expect Southern Water to set out clearly the steps it is taking to maintain its long term financial</p>	N/A	<p>Representation made.</p> <p>Southern Water says that its financial projections and analysis of risks are</p>	<p>No change for the final determination.</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</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>resilience, both now and in the long term.</p> <p>We expect the company to provide Board assurance setting out the steps it has taken to demonstrate that the company will maintain financial resilience in the long term, taking account also of action SRN.LR.C1. We expect this to be accompanied by evidence of support from its equity investors and to be accompanied by independent assurance about the long term viability of the company including its ability to maintain sufficient headroom with respect to its target credit rating.</p> <p>In its future reporting, we expect Southern Water to apply suitably robust stress tests in its long term viability statements in 2020-25.</p> <p>We will continue to engage with the company on issues associated with its long term financial resilience.</p>		<p>based on its position in its representation on the draft determination.</p> <p>Southern Water says it has a robust, well-established, securitised capital structure that supports its ability to raise additional capital when needed. The company sets out that it strongly believes the securitisation of its business to be an important safeguard for customers.</p> <p>Southern Water says it has implemented a substantial increase in the equity of the company in 2019 which will be used to reduce debt to 70% of RCV by April 2020, and reduce interest costs by c£425m in the decade to 2030. This has been achieved through its shareholders subscribing for £700m of additional equity in the regulated company.</p> <p>Southern Water sets out that its approach to long term financial resilience is underpinned by regular and detailed consideration of forecast cash flows, risks, liquidity and operational scenarios that form part of its business as usual risk management process under its three lines of defence model.</p> <p>The company says it has carefully considered the risks it faces and developed severe, reasonable, and plausible scenarios to stress test its plan and included the draft determination cost of capital in its financial projections. It comments that this process builds on work got its long term viability statement in its annual performance report.</p> <p>Southern Water says it has carried out reverse stress testing to determine the financial headroom available under its actual financing structure to withstand persistent under-performance on both</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.</p> <p>Therefore, on account of Southern Water's financial structure and gearing which is above the notional level, the cost of capital in our final determinations that is lower than the draft determinations and limited headroom in its credit ratings, the company may need to take steps to improve its financial resilience in 2020-25 in the context of the final determination and may need to bring forward plans to improve its financial position. The company may need to obtain further equity investment.</p>	<p>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>totex and ODIs with reference to minimum investment grade credit rating. The company says it can maintain financial resilience against its Baa2 target credit rating, albeit with less headroom due to the reduction WACC, in all but the most severe scenarios. It considers that the mitigation plans it has in place, combined with the very low probability of occurrence, mean that these scenarios do not impact the Board's ongoing assessment that the regulated company is financially resilient.</p> <p>Southern Water says that available mitigation includes a flexible dividend policy. It also sets out an additional mitigation aim to repair and enhance its financial resilience at its targeted Baa2 credit rating by amending the terms of some of its inflation-linked swaps to bring forward cash flows.</p> <p>The Board has provided an assurance statement in which it refers to a statement of support from Greensands Holdings which says its support for the company's approach, now and in the future, is consistent with its mandate as long-term infrastructure investors.</p> <p>Southern Water has committed to assess its financial resilience beyond 2025 in its next long term viability statement.</p>		
Securing long-term resilience	SRN.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	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,	See SRN.LR.A3.	See SRN.LR.A3.	See SRN.LR.A3.

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
		capital in very recent market data which will be considered for our 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' and the specific issues we have set out related to the financial resilience of the actual financial structure.			

**Table 2: Southern 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	SRN.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	SRN.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	SRN.RR.D3	<p>We consider that Southern 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 'Southern Water final determination' and the basis on which we consider Southern Water's final determination to be financeable on the basis of the notional capital structure.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	SRN.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 Southern Water are set out in the 'Southern 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"> <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	SRN.RR.D5	<p>We are including a PR24 reconciliation mechanism for business rates in our final determination for Southern Water 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 Southern Water 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	SRN.RR.D6	Southern Water presented an asymmetric risk range for retail activities in its representation.	We include a change in our final determination for Southern Water to reduce the downside risk range for retail activity costs in its representation submission, so that it is symmetrical with its upside risk range. Although we note the company' view on bad debt risks, we note Southern Water is relatively efficient in our retail cost assessment.

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).

