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# SSC PR19 assurance

South Staffs Water

## PR19 APR assurance letter - South Staffs Water plc

31 August 2018

Final

## SSC PR19 assurance

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# Letter of Assurance

**For the attention of the Board** **31 August 2018**

## PR19 assurance

As your technical assurance partner, we helped you to develop an assurance framework for your PR19 business plan. Amongst other things this identified the components of your plan you considered required external assurance. Based on the outputs from the framework, you asked us to review the following broad areas of your plan over June to mid-August 2018.

- Your overarching approach to developing your performance commitments (PCs) and the associated service levels; your approach for linking your customers' preferences to the PCs and their incentives; and the overall outcomes incentive package.
- The process you followed in the development of your totex programme; your approach to allocating totex between price controls and expenditure categories; and your wholesale water cost adjustment claim (CAC).
- Your approach to financial modelling for consistency with Ofwat's rule book and methodology, the rationale supporting some of the associated decisions (eg: use of PAYG and run off levers), and a review of your approach to overall financeability. We have provided you with a separate letter summarising the scope of our work and our findings.
- A limited number of business plan tables that you considered high risk, due to their complexity or inherent difficulties in forecasting data for them (eg: App28 Developer Services).
- Your PR14 reconciliation submission, which we assured at the same time as your annual performance reporting. We provided you with a separate report in July 2018 that detailed the scope of our work and our findings.

Consistent with the agreed scope, for the areas above our reviews and challenge focused on the consistency of your approach or proposals with Ofwat's expectations, methodology and, where applicable, business plan table guidance. In line with our normal assurance work our approach was risk-based and, in the majority of cases, our initial work was based on meetings with your teams.

As with our annual assurance, our feedback and observations focused on identifying reporting and regulatory risks. This letter summarises our observations and we have provided your teams with detailed feedback and comments.

### Observations

Across the areas we reviewed, we observed your teams generally had a good understanding of Ofwat's expectations, as set out through the methodology and any supporting guidance – and that their approaches were broadly consistent with them.

During our meetings with your teams, we observed that your regulation team had been alerting data owners to relevant entries in Ofwat's PR19 methodology queries and responses documents. As the query process was an on-going process, we agreed we would not systematically check that your teams had taken account of all relevant queries.

For the areas we reviewed, we noted that your teams' proposals appeared to be based on a reasonable process. We have provided feedback on possible areas for improvement, including scope in some cases to demonstrate more clearly how proposals aligned with Ofwat's expectations. For the development of your totex programme for example, we considered you could set out more clearly where innovative solutions had been considered to help demonstrate that your optimisation had considered a wide range of options and was aligned to achieving stretching service levels.

We note that during our review of the plan areas, we have discussed some areas of risk.

- For financeability, we considered your approach to modelling appeared consistent with both Ofwat's methodology and rulebook and with your own policies and decisions. You explained that you and your Board are comfortable with your pre-legacy adjustment financial ratios, although we observed that due to your chosen bill profile these ratios display a declining trend. We also observed that financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates. We discuss our observations in relation to financeability more fully in a separate letter.

- During our review of your approach to financeability, we discussed your proposal to keep customers' bills flat in nominal terms (ie: declining by inflation in real terms). We noted that whilst Ofwat might broadly welcome this proposal, we consider it will expect you to:

    - set out how the proposal would work in practice, including setting out how it would work mechanistically with Ofwat's other incentives and how the risk of inflation turning out to be materially higher or lower than your assumptions is allocated;

    - demonstrate that you have considered the intergenerational impact of the proposal, including the potential profile of bills across regulatory periods; and

    - demonstrate how you have reflected customers' views when considering the proposed allocation of risk and intergenerational impacts.

- Following our review of your proposed CAC, we observed that you appeared to have followed a reasonable process in developing it. We recognise this is a material claim for you and observed that you have utilised third parties to help develop your case. As agreed we have not assured work completed by these third parties, though we did recommend that a third-party report on cost and optioneering is appended to your plan. When reviewing the proposed CAC submission, we consider we identified scope to enhance the evidence to support your claim, notably by including support/ a notice from the Drinking Water Inspectorate on the water quality issues you set out – and further analysis to demonstrate more clearly why these were outside your control. We also recommended you set out how you arrived at the value of the claim in more detail and clarified how customers are protected through your proposed PC.

- You explained during our review of your outcomes that the expected impact of your PC out and under performance payments on your return on regulatory equity (RoRE) was potentially inconsistent with Ofwat's expectations and customers' wider interests. We recognise that your teams had not finalised their work and recommended you review the range of inputs used for your P10/P90 RoRE analysis to ensure it was based on the full range of costs and benefits and appropriate forecast service levels.

We discussed the above areas and provided you with more detailed feedback. We understand you have reflected on these risks in finalising your business plan proposals. Consistent with the agreed scope, you managed the completion of any actions and recommendations.

## Conclusion

We observed that you have implemented an assurance framework to target high risk areas of your plan and note that this derived the scope of our assurance. This reflects your internal assurance processes and was designed to build on previous assurance, such as that provided on your annual performance report (including in relation to your approach to cost allocation) and PR14 reconciliation submission.

We observed that your teams had worked hard in developing their approaches to the business plan areas we reviewed. Due to the constraints imposed by the PR19 programme, we note that for some of the areas we reviewed you had not fully finalised aspects of your approach. This was the case for example for your outcomes, where at the time of reviewing your approach you were still finalising: some of the proposed service levels and incentive rates; the justification for changes to the PR14 package of PCs; and the explanation of your approach to incentives, bill phasing and affordability.

Overall, we consider your teams had a good understanding of Ofwat's expectations and reporting requirements for the PR19 areas we reviewed.

**Andrew McGeoghan**
Head of Economic Regulation and Assurance

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# SSC PR19 assurance

South Staffordshire Water

## PR19 assurance - financeability, risk and reward

31 August 2018

Final

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# Letter of Assurance

Attention: Board

**PR19 assurance – financeability, risk and reward**

Ofwat requires each company's business plan to demonstrate that:

- proposed revenues, relative to assumed costs, are sufficient for an efficient company to finance its investment and so deliver its activities, on reasonable terms, while protecting the interests of customers now and in the long term; and
- an efficient company would be able to generate cash flows sufficient to meet its financing needs (once plan components such as totex, cost of capital, PAYG and RCV run-off levers are taken into account).

**Scope of the work**

As agreed, our assurance focused on:

- your understanding of Ofwat's guidance;
- your documentation of policies and assumptions (such as those related to your choices over financial levers, your dividend policy etc);
- the appropriateness of your application of Ofwat's guidance (and assumptions you made) in your financial modelling;
  - on your actual capital structure;
  - on Ofwat's notional structure (including RORE scenarios); and
- the narrative supporting your assumptions and subsequent proposals.

We reviewed these areas based on the level of materiality to price limits and risk of reputational damage.

We agreed the derivation of the inputs to the financial model under the company's actual capital structure, and the downside scenarios under your actual capital structure, were out of scope. We also agreed that any statement about whether your plan is financeable is reserved for you as the Board and therefore outside our scope.

**Overall we consider that:**

- **you have appropriate processes in place to populate the Ofwat financial model with data consistent with the Ofwat requirements;**
- **when running Ofwat's financial model you have followed the general guidance in Ofwat's PR19 methodology statement and the specific guidance provided in Ofwat's financial model;**
- **where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions; and**
- **your final commentaries are consistent with the outcome of your financial modelling, in that they explain the key drivers of any financeability constraints and the reasons for your chosen approach.**

## Conclusion

When running Ofwat's financial model you have followed the general guidance in Ofwat's PR19 methodology statement and the specific guidance provided in Ofwat's financial model. Where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions.

As part of our work we reviewed your business plan narrative, and confirmed that it was consistent with your modelling and the outputs from your modelling. As requested we provided challenge on your key modelling assumptions, for example your arguments to support: your decision not to use the financeability levers; and the level and profile of your financial ratios. We observed that your assumptions align with your agreed policy decisions and understand that you have fully discussed these assumptions as a Board.

We provided your team with feedback that set out in detail the scope of our work, the specific activities we undertook and our findings.

Yours sincerely

**Nigel Sanders**
**Director of Operations**

## Important note about your report



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# 1. Introduction

Financeability is a core feature of Ofwat's price reviews and its approach is driven by two of its primary duties – to protect consumers' interests and to secure that efficient companies can finance their functions. One of the primary indicators of a companies' financeability is its credit rating. Ofwat requires the companies to maintain an investment grade credit rating. This is demonstrated by evidence that they can cover key financial ratios.

You will need to provide evidence in your PR19 Business plan that you have used robust processes, data and information, plus appropriate strategies, to satisfy yourself that South Staffordshire Water (the Company) remains financeable at appointee level.

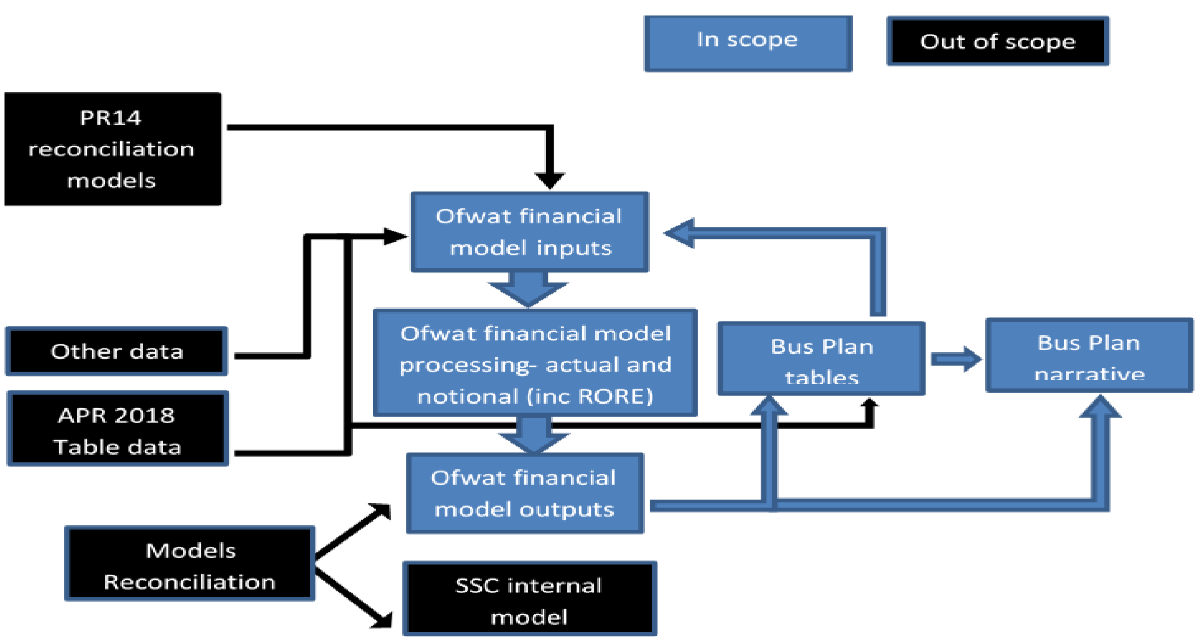
In addition, Ofwat expects companies to align the interests of companies and their investors with those of their customers. Therefore, you will need to make an assessment of the balance between risk and return in your plan, ensuring it is compatible with the Company's risk appetite. One of the ways Ofwat expects you to assess this is by using return on regulated equity (RoRE) modelling to assess the potential range of risk and return exposure.

# 2. Approach

We agreed prior to commencing this task that the scope would cover the following key elements (see also figure 1 below):

- the key assumptions underpinning data inputs;
- your modeling processes;
- the financial model outputs; and
- the consequential commentary on key assumptions the financial model and outputs.

**Figure 1 Elements of the financeability that were in and out of scope**



Consistent with our other assurance work for you, we agreed we would take a risk based approach to reviewing the above.

Our assurance was based on challenging your teams' processes, data and assumptions via a combination of:

- face to face meetings (using live active versions of Ofwat's financial model); and
- desk top reviews.

We agreed the following components were out of scope:

- derivation of the inputs to the financial model under the company's actual capital structure; and
- downside scenarios under your actual capital structure.

We note this data was subject to your own internal assurance processes.

We also agreed that any statement about whether your plan is financeable is the preserve of your Board and therefore outside our scope.

# 3. Findings

## 3.1 Overall findings

We worked closely with your financial modelling team in a constructive and collegiate manner. Any material issues identified during the assurance process were subsequently resolved to your team's satisfaction. The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statement and the specific guidance provided in Ofwat's financial model. There are a limited number of instances where Ofwat's guidance lacks prescription or is open to interpretation. In these instances, you have made what appear to be reasonable assumptions.

The financial modelling is naturally a back ended process, subject to a number of iterations as policy decisions and the associated data key inputs are locked down. The completion of Jacobs's assurance process has been iterative and back end loaded too. Consequently, there is inevitably some risk of inconsistency in data between the business plan tables and Ofwat's financial model, but this should be mitigated by use of your internal assurance functions.

The team also demonstrated that your financial model input data, and your assumptions, reflect your agreed policy decisions and we understand that these assumptions have been fully discussed at SSC Board. We have observed that due to your chosen bill profile these ratios display a declining trend. We also observed that financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

We consider your narrative is consistent with your modelling assumptions and the subsequent outputs from that modelling.

## 3.2 Material observations

There are no material observations.

## 3.3 Non-material observations

In addition to the overall findings noted above, we also note the following non-material observations.

### Financial modelling - actual structure: base case

You are proposing a profile of flat nominal bills over the period 2020-2025. Consequently, financial ratios weaken over the period as costs inflate. Average financial ratios over the period 2020-2025 are consistent with your current and target credit ratings but there is a risk that the declining trend might be of concern to the rating agencies and therefore to Ofwat too. However, you have mitigated this risk by explaining in your narrative that the volume and profile of expenditure in the period 2020-2025 is atypical. You are clear that you have also modelled projections from 2025 to 2030 to illustrate how financial ratios will recover over the longer term.

### Notional Structure Modeling

The Ofwat financial model includes an overwrite tab that facilitates the notionalisation of a company's financial structure and financial costs, namely:

- capital structure;
- cost of capital - appointee and wholesale;
- debt real fixed;
- debt nominal fixed;
- debt nominal floating;
- share structure;
- shareholder distribution; and
- retail margin

Ofwat's financial model also includes a tab providing guidance on how to complete the required data inputs. In a limited number of instances, the guidance lacks prescription. Where this is the case, we consider you appear to have made reasonable and logical assumptions.

- You have assumed 70% of the real Cost of equity is distributed to shareholders via a dividend (dividend yield) and the remaining 30% is annual real dividend growth. Your approach is consistent with both corporate finance theory and Ofwat's assumption at PR14

- Real rate of interest on index linked debt – you have assumed financial year average RPI as you consider that this best reflects the fact the Index linked debt instruments can be inked to RPI at varying points in the year

Your original retail balance sheet included an amount of cash. To achieve the Ofwat prescribed notional gearing for the appointee. You moved this cash to the wholesale balance sheet. Consequently, the retail balance sheet does not balance. We note Ofwat might choose to standardise these assumptions across all companies when undertaking its notional modelling. You consider the impact of any divergence from your assumptions is likely to have no material impact on the revenue requirement or the resulting financial ratios.

Your financial ratios are weaker compared to those modelled on your actual structure. We consider this position reinforces or recommendation that you seek additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

### Legacy adjustments

You have followed Ofwat's guidance and presented you financial ratios prior to any legacy adjustments. However, we have observed that your ratios will marginally improve when legacy adjustments are applied, presuming you are able to get the desired outcome from Ofwat in relation to your developer revenue PR14 reconciliation.

### RORE sensitivities

Ofwat prescribed a number of scenarios that should be modelled to establish potential RORE ranges. We sample checked your calculation of the required input data. You appear to have followed the Ofwat guidance and where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions.

You consider there to be some inaccuracies in the RORE ranges produced by Ofwat's financial model. You have informed us that you will include relevant commentary in your business plan.

# 4. Conclusions

We worked closely with your financial modelling team in a constructive and collegiate manner. The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statement and the specific guidance provided in Ofwat's financial model. There are a limited number of instances where Ofwat's guidance lacks prescription or is open to interpretation. In these instances, you have made what appear to be reasonable and defensible assumptions.

The team also demonstrated that your financial model input data, and your assumptions, reflect your agreed policy decisions. We understand that you have fully discussed these assumptions at SSC Board. We have observed that due to your chosen bill profile, your ratios display a declining trend. We also observed that your financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

A number of Business Plan tables feed and/or are fed by the financial model. We sampled a limited number of these egg relating to natural and modelled PAYG and RCV run off rates. At the time of drafting this report, data was still subject to change. You have confirmed that any changes will be assured through your internal process, to ensure consistency between models tables and consequential narrative.