PR19 draft determinations: key movements

Oxera Thought Leadership

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1 Key movements: efficiency and finance

Ofwat's initial assessment of company business plans (IAPs), published in January, presented a challenge to water companies in England and Wales. In February, we set out the key messages on efficiency and finance issues in 'A challenging initial assessment for the water companies in England and Wales'.[1]

At the IAP stage, Ofwat categorised three companies' business plans[2] as 'fast track', and the draft determinations for these three were published in April. However, Ofwat's view has since changed, with two of them now having a wider cost gap than at the fast-track determinations.[3] The remaining companies were asked to resubmit their plans, meaning a long wait until July to discover their fate.

A week has now gone by since publication of the non-fast-track draft determinations, allowing some time for reflection. We explore below the key movements on efficiency and finance issues since the IAPs—in particular, to what extent has the settlement got tougher or more accommodating?

2 Efficiency

In examining companies' allowed expenditure, an important consideration is the extent to which past and forecast cost levels are efficient. The key outcomes in the non-fast-track draft determinations are as follows.

[1] Oxera (2019), 'A challenging initial assessment for the water companies in England and Wales', *Agenda*, February.
[2] Severn Trent Water, South West Water and United Utilities.
[3] The slow-track determinations provide an updated view for the fast-track companies as Ofwat moves to its final determinations—that is, Ofwat does not provide a revised draft determinations allowance for these companies.

- The industry total expenditure (TOTEX) challenge is 11%[4], slightly lower than the challenge of 13%[5] at the IAP stage.

- Ofwat has changed how it allocates expenditure between base and enhancement expenditure, making any comparison of outcomes at this level of disaggregation between the IAP and draft determinations stages more difficult. We present the comparison below, but it is not like-for-like.

- The industry base total expenditure (BOTEX) challenge is 4%[6], which is less demanding than at the IAP stage (c. 8%[7]).

- The industry wholesale enhancement challenge is 31%[8], which is more demanding than at the IAP stage (c. 26%[9]). This may be driven by more challenging benchmarks based on the resubmitted company business plan data.

As noted, Ofwat has made changes to the way it defined and presented results on base and enhancement expenditure at the draft determinations. This may affect companies' understanding of the changes since the IAPs.

While Ofwat's overall cost assessment methodology remains conceptually similar to that at the IAPs, there are a few important changes, detailed below.[10]

2.1 Base expenditure

BOTEX is expenditure to maintain steady-state levels of service to customers. This includes base OPEX and capital maintenance expenditure.

Compared to the IAPs, Ofwat's approach to assessing future expenditure requirements sees the following few changes.

- For modelling purposes, base costs now include growth expenditure. However, Ofwat has not also added any corresponding growth-related cost drivers to the models.[11] This is because it views such costs as 'business as usual', captured through the drivers already included in the base cost models. Despite Ofwat's view, these models may still not explain future increases in growth expenditure.

- Ofwat has amended its approach to forecasting some of the cost drivers, with a move to using external sources, such as the ONS, for connected properties, as some companies had suggested—its former (IAP) position being to base them on historical values.

- For labour costs, there is now an ex ante allowance to account for real price effects. This is based on OBR forecasts (1.1% p.a., or approximately 0.4% p.a. once weighted for Ofwat's view of the labour cost share). This is accompanied by a 'true-up' at PR24, based on outturn manufacturing wage growth.

[4] Ofwat (2019), 'PR19 draft determinations, securing cost efficiency technical appendix', 18 July, Table A1.1.
[5] Ofwat (2019), 'Technical Appendix 2 - Securing cost efficiency', 31 January, Table 4.
[6] Ofwat (2019), 'PR19 draft determinations, securing cost efficiency technical appendix', 18 July, Table A1.2.
[7] Ofwat (2019), 'Technical Appendix 2 - Securing cost efficiency', 31 January, Table 5.
[8] Oxera analysis of Ofwat (2019), 'Feeder model: Enhancement aggregator', July.
[9] Oxera analysis of Ofwat (2019), 'Feeder model: Enhancement aggregator', January.
[10] Some historical data used in the modelling has also changed.
[11] Indeed, the specification of its BOTEX models is the same as at the IAP stage, with the exception of Bioresources (which has one additional driver).

2.2 Enhancement expenditure

Enhancement expenditure includes CAPEX and OPEX to improve service levels, meet demand, or improve water quality or the environment.

The approach in the non-fast-track draft determinations differs to that set out at the IAP stage, in the following respects.

- Enhancement costs are now assessed including enhancement OPEX, not just enhancement CAPEX.

- In response to the IAPs, when resubmitting their plans some companies reduced their enhancement cost requirements. Ofwat used these revised costs in its enhancement benchmarking analysis, which might have resulted in a more stringent cost challenge.[12]

- For some companies, part of the enhancement gap is driven by a difference in Ofwat's approach to reallocation. While, at the IAP stage, a number of cost lines were reallocated to the forward-looking growth enhancement models, the assessment of growth at the draft determinations was based on backward-looking econometric models.[13] As such, it may be difficult to account for any legitimate future increases in unit costs in this area, although Ofwat does do a 'deep dive' to examine any large divergences between its view and that of the company.

- The allowance for leakage enhancement costs has changed from 15% to the 2024–25 forecast industry upper-quartile (UQ) leakage performance. While Ofwat makes an allowance for leakage enhancement funding for companies going beyond this UQ threshold, below the threshold it considers improved leakage to be achieved within the BOTEX allowance.

- Previously, Ofwat capped company expenditure within a specific enhancement activity to the minimum of the model prediction and the company's submission. This has been amended slightly for supply–demand balance expenditure and Water Industry National Environment Programme (WINEP) expenditure. In these cases, the allowance has been set at the minimum of Ofwat's view and the company's view of costs at a *programme* (rather than *activity*) level. While this better accounts for cost allocation and trade-offs within these two specific cases, such issues remain across the remainder of company expenditure.

2.3 Retail costs

The approach to retail expenditure assessment in the draft determinations contains some revisions to the IAPs:

- two models have been dropped and one model has been amended with an additional driver. However, the main change is in the definition of the benchmark. The efficiency challenge on residential retail now gives equal weight to the forward-looking UQ and the historical UQ, whereas, at the IAP stage, Ofwat was relying solely on the forward-looking UQ;

[12] Ofwat does not set a lower cost allowance than that at the IAP stage for a company that manages to reduce its costs.
[13] These lines (referred to as 'freeform' lines) now remain as company enhancement submissions, although the Ofwat allowance is entirely within base expenditure. This serves to overstate the scale of the enhancement challenge and understate the challenge on base plus growth expenditure.

- while the efficiency challenge reduces from 29% to 16.5%, the data and modelling updates mean that the company-specific gaps (and hence expenditure allowances) have changed both upwards and downwards.

3 Finance issues

Since the IAP stage, there have been movements in the cost of capital, financeability and run-off rates, plus some new questions about how to put the sector 'back in balance'. These are reviewed below.

3.1 Cost of capital

The cost of capital is important as it (in part) determines companies' allowed returns . The key message is that, since Ofwat's early view in December 2017, the cost of capital has declined from 2.4% to 2.19% (in real RPI terms). This drop—of approximately 20bp—is driven by:

- a reduction in the risk-free rate (54bp from -0.88% to -1.42% real RPI); and
- a reduction in the notional equity beta from 0.77 to 0.71 (largely due to a higher debt beta, which has increased from 0.1 to 0.125).

The cost of equity has decreased from 4.01% to 3.46% real RPI. The costs of new and embedded debt have both decreased marginally. However, the overall cost of debt has increased marginally, from 1.33% to 1.34% real RPI, due to the change in the ratio of embedded to new debt from 70:30 to 80:20.

The cost of capital estimate in the draft determinations is based on the cut-off date of 28 February 2019. Ofwat notes that the estimate would be 37bp lower if more recent market data (with a 28 June 2019 cut-off date) were considered instead.[14]

3.2 Financeability

At the IAP stage, Ofwat stated that it would assess financeability 'in the round', and that it did not agree with the tightening of thresholds for credit rating metrics that Moody's, Fitch, and S&P had implemented at the time.

Ofwat added that, while assessing financeability, it would look at average metrics over the price control, trends in metrics, and so on, rather than focusing on individual metrics in a single year.

Nevertheless, companies were required to show that they were financeable on both a *notional* and an *actual* basis.

In the draft determinations, Ofwat has targeted a credit rating for notional financeability of BBB+/Baa1—two notches above the minimum investment-grade rating. For companies with a lower target credit rating, Ofwat notes:

> We apply a higher evidence bar in assessing whether the company demonstrates that the credit rating is sustainable for long-term financeability and financial resilience when BBB/Baa2/BBB (Fitch, Moody's, S&P) has been targeted for the actual structure, given the lower level of headroom to protect against cost shocks.[15]

Table 2.1 summarises the financial ratios for draft determinations for notional company structures (2020–25 average).

[14] Ofwat (2019), 'PR19 draft determinations: Cost of capital technical appendix', 18 July, p. 8.
[15] Ofwat (2019), 'PR19 draft determinations: Aligning risk and return technical appendix', 18 July, p. 52.

Table 3.1 Financial ratios at draft determinations

	Gearing (%)	Adjusted cash interest cover ratio (AICR)	Funds from operations/ net debt (%)
Anglian Water	60.80%	1.44	9.28%
Dŵr Cymru	60.49%	1.50	7.56%
Hafren Dyfrdwy	64.29%	1.74	11.99%
Northumbrian Water	59.60%	1.52	9.96%
Severn Trent Water	60.04%	1.48	10.02%
South West Water	57.88%	2.00	11.93%
Southern Water	61.74%	1.71	10.89%
Thames Water	60.89%	1.46	8.80%
Wessex Water	61.33%	1.67	9.23%
United Utilities	58.89%	1.54	9.81%
Yorkshire Water	61.22%	1.94	9.35%
Affinity Water	60.78%	1.50	9.62%
Bristol Water	59.10%	2.52	13.29%
Portsmouth Water	58.62%	1.48	8.33%
SES Water	62.16%	1.46	13.29%
South East Water	59.74%	2.22	9.64%
South Staffs Water	61.46%	1.66	13.04%

Source: Ofwat (2019), 'PR19 draft determinations: Aligning risk and return technical appendix', 18 July, p. 63.

To address notional financeability concerns for some companies, Ofwat is intervening as follows:

- Portsmouth Water and Affinity Water—Ofwat's financeability assessment assumes that equity contributions are necessary to finance investment in the notional company structure;
- Southern Water, Thames Water and Wessex Water—Ofwat's assessment is that notional financeability can be maintained with reductions to the dividend yield assumed for the notional financial structure;
- Affinity Water and Portsmouth Water—Ofwat is intervening to reduce PAYG revenue brought forward from future customers.
- Dŵr Cymru, SES Water and Thames Water—Ofwat is bringing forward revenue through an increase in PAYG rates, to provide sufficient headroom to maintain a minimum investment-grade credit rating.

With regard to changes in PAYG rates to address issues relating to notional financeability, both Moody's and Fitch credit rating agencies note that they will continue to remove the regulatory depreciation, as well as excess PAYG, when calculating company-specific interest cover ratios.[16,17]

Ofwat has set the dividend assumption for financeability of a notional company at 3.15% with a growth rate of 1.32%.

It considers that efficient companies should be capable of earning their base equity return, and is therefore consulting on a proposed change to the

[16] Moody's Investor Service (2019), 'Regulated Water Utilities – UK, Ofwat tightens the screws further', 26 July.
[17] Fitch Ratings (2019), 'Fitch Ratings: Ofwat Price Review Intensifies Pressure on UK Water Sector', 26 July.

approach to assessing the financing cost risk range for the final determinations. In its draft determinations it has intervened to adjust the RORE risk ranges for some companies.

3.3 PAYG/RCV run-off rates

In the 2018 initial business plan submissions, companies proposed adjustments to PAYG and RCV run-off rates to smooth bills within the price review period, in order to address financeability constraints for the notional capital structure, to alter the rate of transition to CPIH, or to address affordability issues for customers.

Ofwat has accepted the proposed run-off rates for some companies, but in the draft determinations has intervened for the following:

- Hafren Dyfrdwy, Southern Water, Wessex Water and South Staffs Water—Ofwat is removing the revenue brought forward from future customers (through proposed PAYG or RCV run-off adjustments) since there is insufficient evidence to support the proposed rates;
- Affinity Water and Portsmouth Water—as noted earlier, Ofwat is reducing PAYG revenue brought forward from future customers based on its assessment of financeability for the notional company structure;
- Dŵr Cymru, SES Water and Thames Water—as noted earlier, Ofwat is bringing forward revenue through an increase in PAYG rates, to provide sufficient headroom to maintain a minimum investment-grade credit rating.

3.4 Putting the sector back in balance

Companies were asked to meet, in their business plans, the requirements set out in the 2018 document, 'Putting the sector back in balance', with a view to aligning their financial structures, dividend policies and executive compensation with customer interests.[18]

At the draft determinations, Ofwat has *not* accepted the amendments to the default sharing gearing outperformance mechanism proposed by Thames, South Staffs and Bristol Water, and has asked the companies to accept its mechanism for the final determinations.

On dividends, Ofwat expects companies to demonstrate transparently that their dividend policy for 2020–25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determinations.

On executive pay, Ofwat expects companies to commit performance targets that will be continually assessed, to ensure that they continue to be 'stretching' throughout 2020–25.

4 Overall

We started by asking: 'to what extent has the settlement got tougher or more accommodating than at the IAP stage?'

The non-fast-track draft determinations are certainly more challenging on finance than Ofwat's early view. The decline in the cost of capital, and the

[18] Ofwat (2018), 'Putting the sector in balance: position statement on PR19 business plans', July.

further expected decline based on recent data, are likely to raise financeability concerns in the industry.

When it comes to efficient costs, the views of Ofwat and of the companies continue to diverge, especially in relation to enhancement expenditure. At the TOTEX level, the gap has reduced by only two percentage points, even though, in response to the IAP, some companies reduced their costs and provided additional evidence on their expenditure needs. By contrast, at the equivalent point in the PR14 process, there was a much narrower gap between company submissions and Ofwat's assessment.[19] Any movements between now and the final determinations are likely to be limited to company-specific issues.

And what now? Companies and other stakeholders have until 30 August to provide their representations to Ofwat on the non-fast-track draft determinations, with the final determinations for all companies due on 11 December. Companies seeking to change Ofwat's mind have just over four months to present clear arguments backed up by robust evidence.

For companies unhappy with the outcome, there is always the prospect of referring the final determinations to the Competition and Markets Authority—not a decision to be taken lightly. The CMA is very thorough, and appeals take up a significant amount of senior management time, potentially delaying key business plan decisions. As ever, clear arguments backed up by robust evidence are key.

[19] The TOTEX gap at the PR14 draft determinations had reduced to 2.9% from the PR14 risk-based review gap of 5.0%. By contrast the PR19 draft determinations gap is 11.3%, from 13.3% at the PR19 IAP.