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Water sector draft determinations: a stocktake

Contact
Leon Fields
Senior Consultant

Ofwat's July 2019 draft determinations for water companies in England and Wales signal that the regulator is toughening its stance on allowed returns, cost efficiency and performance incentives. Credit rating agencies have provided their own thoughts on what this means for the sector. We go under the bonnet to explore the detail

Ofwat's initial assessment of company business plans (IAPs), published in January this year, presented a challenge to water companies in England and Wales.[1] At that stage, Ofwat categorised three companies' business plans as 'fast-track'.[2] These received early draft determinations back in April.[3]

The remaining ('slow-track'/'significant scrutiny') companies were asked to resubmit their plans—which meant that they had a long wait until July to discover their fate. The credit rating agency Moody's sees the July draft determinations as a 'tightening of the screw', and singles out reduced allowed returns, a toughening stance on cost efficiency, and a downside skew in the performance incentives.[4] We explore these issues in more detail below.

Finance

Since the IAP stage, there have been movements in the cost of capital and financeability, and new questions have arisen about how to put the sector 'back in balance'.

Cost of capital

The cost of capital is an important determinant of a company's allowed returns. 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);
- 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 a cut-off date of 28 February 2019. Ofwat notes that the estimate would be 37bp lower if more recent market data (up to 28 June 2019) were considered.[5]

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.

Companies were required to provide Board assurance that they were financeable on both a *notional* and an *actual* basis.

In the July 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:[6]

> 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.

To address notional financeability concerns for some companies, Ofwat has intervened 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 pay-as-you-go (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.

Nonetheless, with regard to the changes in PAYG rates to address notional financeability, both Moody's and Fitch have said they will continue to remove the regulatory depreciation, as well as excess PAYG, when calculating company-specific interest cover ratios.[7]

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

Putting the sector back in balance

In their business plans, companies were asked to meet 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.[8]

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 to performance targets that will be continually assessed, to ensure that they continue to be 'stretching' throughout 2020–25.

Efficiency

In examining companies' allowed expenditure, an important consideration is the extent to which past and forecast cost levels are efficient. Overall, the industry total expenditure (TOTEX) challenge is 11%,[9] which is slightly lower than the challenge of 13%[10] at the IAP stage.

Ofwat has made changes relative to the way it defined and presented results on base and enhancement expenditure at the July draft determinations, but enhancement still has a much larger challenge than base expenditure. This change in Ofwat's approach makes it challenging for companies to understand the movements since the IAPs.

While Ofwat's overall cost assessment methodology remains conceptually similar to that at the IAPs, there are a few important changes as detailed below.[11]

Base expenditure

Base expenditure (BOTEX) is expenditure to maintain steady-state levels of service to customers. This includes base OPEX and capital maintenance expenditure. Compared with the IAPs, Ofwat's approach to assessing future expenditure requirements sees the following changes.

- For modelling purposes, base costs now include growth expenditure. However, Ofwat has not added any corresponding growth-related cost drivers to the models because it views such costs as being captured through the drivers already included. 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 Office for National Statistics)[12] for connected properties, as some companies had suggested.
- For labour costs, there is now an ex ante allowance to account for real price effects. This is based on Office for Budget Responsibility[13] 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.

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.[14]
- At the IAP stage, Ofwat used forward-looking growth enhancement models, while at the draft determinations, as stated above, it has included these costs in its backward-looking base expenditure models.[15] As such, it may be difficult to account for any legitimate future increases in unit costs in this area, although Ofwat does undertake 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. For supply–demand balance expenditure and Water Industry National Environment Programme (WINEP)[16] expenditure, the capping now occurs at a *programme* (rather than an *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.

Retail costs

The approach to retail expenditure assessment in the July draft determinations contains the following 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 relied solely on the forward-looking UQ.
- 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.

Performance incentives

Within the draft determinations, Ofwat has made very few concessions to companies on performance commitments (PCs) and outcome delivery incentives (ODIs) following the IAPs and companies' business plan resubmissions. In part this is because many companies shifted position towards Ofwat's view at resubmission. However, where concessions were sought by companies, Ofwat has given little ground in the draft determinations.[17]

Performance commitments

Of particular interest is Ofwat's approach to 'common' and 'comparable' PCs (and the associated ODIs), which cover:

- UQ measures—supply interruptions, pollution incidents and internal sewer flooding;
- reducing water demand—leakage and per capita consumption;
- statutory measures—the compliance risk index and treatment works compliance;
- asset health measures—mains repairs, unplanned outage, sewer collapses, external sewer flooding, sewer blockages, water quality, and low pressure;
- resilience measures—risks of sewer flooding in a storm and severe restriction in a drought;
- vulnerability measures—the priority services register;
- customer experience—the customer measure of experience (C-MeX) and the developer services measure of experience (D-MeX).

Focusing on the UQ measures, by the time of the April 2019 business plan resubmissions most companies stated that they would be able to achieve UQ performance by 2025. However, some companies sought concessions—such as altering the profile of the targets over time, or introducing deadbands to reduce their risk exposure.

Furthermore, four companies[18] argued that others in the sector had put forward overly ambitious forecasts, and some argued that applying single industry-wide performance levels for the three UQ PCs was inappropriate due to company-specific issues (and that different PCs or deadbands should apply).

Ofwat's response in the draft determinations has been to give very little room.

- Ofwat accepts the transition argument for supply interruptions—

that a common glide path to UQ performance is necessary. However, a glide path has been ruled out for pollution incidents and internal sewer flooding.

- Ofwat has, on the basis of the evidence it has reviewed, rejected virtually all claims that company-specific factors make the targets unachievable.[19]

- Ofwat has ruled out using deadbands (given the company-specific evidence).

Overlain on this are the ODIs. Ofwat accepts that ODI rates will differ by company (including for common PCs). However, it wants companies to adopt more financial incentives than are contained in their resubmitted plans, and it does not want companies to adopt outperformance rates that exceed underperformance rates.

Ofwat's position on PCs and ODIs therefore translates into a downward skew in the prospective financial outcomes for companies.

A focus on leakage

The leakage targets are particularly challenging. Ofwat has sought to increase PCs for some companies, and to push laggards further to close the gap between them and the UQ. It has taken into account:

- whether the target in resubmissions is forecast UQ performance;[20]

- whether the annual percentage reduction proposed is above 15%;

- the performance of the company on leakage in the past and its water resources plan going forward;

- the levels that Ofwat considers should be delivered by base cost allowances.

As a result, Ofwat has stood firm on its funding allowances, stating:[21]

> Where companies propose leakage reductions of greater than 15% by 2024-25, we consider whether these reductions are deliverable within base funding and adjust performance commitment levels where appropriate. Consistent with our approach to setting efficient costs, we disallow company claims for enhancement funding to deliver base service including stretching reductions in leakage. We encourage companies to challenge themselves to go beyond stretching levels in [the] 2020-25 period and note that companies can earn outperformance payments for delivering beyond stretching performance levels. Our cost assessment approach allows additional enhancement expenditure to those companies that propose performance levels beyond the upper quartile in 2024-25.

In effect, no additional funding has been made available for achieving the 15% reduction, and little additional funding has been made available for going beyond this target (according to Ofwat, it is provided indirectly through the enhancement expenditure modelling and/or is left to ex post ODI payments).[22]

The draft determinations contain particularly stretching targets for some companies:

- Thames Water has a stretching performance level of a 25% reduction (based on the highest percentage improvement proposed in the sector);

- Affinity Water and Yorkshire Water need to achieve 20% reductions. Ofwat considers this to be covered by base cost allowances (with the proviso that companies can earn ODI outperformance payments for delivering beyond these levels). The deadbands proposed by the two companies have not been incorporated.

Overall messages and next steps

On financial issues, the non-fast-track draft determinations are certainly more challenging than in Ofwat's early view. The decline in the cost of capital, and the further expected decline based on recent data, are likely to raise financeability concerns in the industry.

On TOTEX, the views of Ofwat and of the companies continue to diverge, especially in relation to enhancement expenditure. This is in contrast to the equivalent point in the PR14 review, where there was a much narrower gap between company submissions and Ofwat's assessment.[23] Movements between now and the final determinations are likely to be limited to company-specific issues.

On PCs and ODIs, Ofwat has largely dismissed company concerns regarding the achievability of the targets, and the financial incentives are downward-skewed.

So what now? Companies have until 30 August to provide their representations to Ofwat. Final determinations are due on 11 December. For companies that are unhappy with the outcome, there is always the option to refer the final determinations to the Competition and Markets Authority—but this is not a decision to be taken lightly. As ever, clear arguments backed up by robust evidence are key.

Contact

leon.fields@oxera.com

Alan Horncastle, Partner

Peter Hope, CFA, Partner

[1] Oxera (2019), 'A challenging initial assessment for the water companies in England and Wales', *Agenda*, February, https://bit.ly/31CpGXE.

[2] Severn Trent Water, South West Water and United Utilities.

[3] The July slow-track determinations also provide an updated view for the fast-track companies as Ofwat moves to its final determinations. Ofwat's view has moved on since April, with two of the fast-track companies now having a wider cost gap than before.

[4] Moody's Investor Service (2019), 'Regulated Water Utilities – UK, Ofwat tightens the screws further', 26 July.

[5] Ofwat (2019), 'PR19 draft determinations: Cost of capital technical appendix', 18 July, p. 8.

[6] Ofwat (2019), 'PR19 draft determinations: Aligning risk and return technical appendix', 18 July, p. 52.

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

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

[9] Ofwat (2019), 'PR19 draft determinations, securing cost efficiency technical appendix', 18 July, Table A1.1.

[10] Ofwat (2019), 'Technical Appendix 2 – Securing cost efficiency', 31 January, Table 4.

[11] Some historical data used in the modelling has also changed.

[12] The Office for National Statistics (ONS) is part of the UK Statistics Authority, a non-ministerial department. The ONS is the largest independent producer of official statistics in the UK.

[13] The Office for Budget Responsibility (OBR) is a UK non-departmental public body. It provides independent economic forecasts and independent analysis of the public finances.

[14] Ofwat does not set a lower cost allowance than that at the IAP stage for a company that manages to reduce its costs.

[15] These costs (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.

[16] The WINEP is a set of actions that the Environment Agency has asked water companies in England to complete in order to achieve their environmental obligations over the 2020–25 period.

[17] Our analysis is based on a detailed annex: Ofwat (2019), 'PR19 draft determinations: Delivering outcomes for customers policy appendix', July.

[18] Anglian Water, Thames Water, Dŵr Cymru and South East Water.

[19] This is with the exception of Hafren Dyfrdwy, which is regarded by Ofwat as a special case.

[20] Measured in terms of leakage per property and per day, and leakage per kilometre of main per day.

[21] Ofwat (2019), 'PR19 draft determinations: Delivering outcomes for customers policy appendix'.

[22] There is, however, some smoothing of the leakage ODIs. Ofwat considers that the three-year average approach to setting the PC level for leakage (and per capita consumption) reduces the impact of extreme weather on out- and underperformance payments and hence any impacts on customer bills.

[23] 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 July 2019 draft determinations gap is 11.3%, from 13.3% at the PR19 January 2019 IAP.