



## **PR19 IA Assurance**

South Staffordshire and Cambridge Water

### **PR19 Draft Determination assurance - financeability, risk and reward**

29 August 2019

Final



## PR19 Draft Determination assurance – Risk and reward

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## Letter of Assurance

Attention: SCC Board  
CC: Heather Richardson

29<sup>th</sup> August 2019

To the Board

### **PR19 Response to Ofwat's Draft Determination – financeability, risk and reward assurance**

In July 2019, Ofwat published its Draft Determination of water companies' business plans for 2020 – 2025.

Ofwat challenged the SSC business plan in several areas. This letter refers to the Ofwat challenges relating specifically to risk and return.

You subsequently asked Jacobs to review the basis of the Company's intended response to the Draft Determination.

### **Scope of the work**

You asked Jacobs to review your:

- financial modelling (inputs & outputs)
- financeability assessment (ratios level and inferred credit quality);
- output data from your Monte Carlo modelling and its use in your P10/P50/P90 analysis; and
- your supporting narrative.

Any statement about whether your plan is financeable is the preserve of your Board, and out of scope of the work carried out by Jacobs.

### **Findings**

The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statements and the specific guidance provided in Ofwat's financial model. It appears that your financial model input data, and your assumptions, reflect your agreed policy decisions in response to Ofwat's draft determination.

Your financial modelling, based on your DD representation, produces financial indicators under both the Ofwat notional and your actual capital structure, that, are consistent with your target credit rating.

Under the WACC stress test scenario your financial modelling under your actual capital structure produces financial ratios potentially too weak to support your target credit rating and under a combination of scenarios, potentially too weak to support a credit rating that is investment grade.

Your P10/P50/P90 analysis appears to be consistent with the outputs of your Monte Carlo modelling and this analysis infers the potential for the ODI for Compliance Risk Index (CRI) to be disproportionately punitive for SSC.

We reviewed your developing narrative which was at that time consistent with the outcomes of your assumptions, modelling and analysis. We note your commitment to ensure your final supporting narrative is

consistent with the final outcome of your financial modelling, the financeability assessment., and your Monte Carlo & P10/P50/P90 analysis.

We understand that you have fully discussed these issues at SSC Board.

We provide more detail on the scope of our work, the specific activities we undertook and our findings in the main report.

### **Conclusion**

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 statements and the specific guidance provided in the latest version of Ofwat's financial model;
- your financial modelling reflects the decisions of your Board in relation to credit quality, in response to Ofwat's Draft Determination; and
- your P10/P50/P90 analysis appears to be consistent with the outputs of your Monte Carlo modelling.

We note your commitment to ensure your final supporting narrative is consistent with the outcome of your financial modelling, the financeability assessment, and your Monte Carlo & P10/P50/P90 analysis.

Yours sincerely

**Alexandra Martin**  
**Divisional Director (Assurance Service Delivery)**

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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 indicators.

In July 2019, Ofwat published its Draft Determination of water companies' business plans for 2020 – 2025. Ofwat challenged your business plan in several areas. This memo refers to the Ofwat challenges relating specifically to risk and return.

You subsequently asked Jacobs to review SCC's assumptions, analysis and supporting narrative in its response to the draft determination.

## 2. Approach

We agreed the scope would cover the following key elements:

- financial modelling (inputs & outputs)
- financeability assessment (ratios level and inferred credit quality); and
- output data from your Monte Carlo modelling and its use in your P10/P50/P90 analysis; and
- your supporting narrative

Any statement about whether your plan is financeable is the preserve of your Board, and out of scope.

## 3. Findings

### 3.1 Overall findings

You have modelled a number of scenarios based on the challenges and your response to Ofwat's draft determination. This modelling produces financial indicators under both the Ofwat notional and your actual capital structure, that, are consistent with your target credit rating.

Under the WACC stress test scenario your financial modelling under your actual capital structure produces financial ratios potentially too weak to support your target credit rating and under a combination of scenarios, potentially too weak to support a credit rating that is investment grade.

The table below provides a summary of key financial indicators under the base case and a number of scenarios.

		AICR (Moody's)	FFO/Net Debt (Ofwat alternative)	Gearing
<b>Base Case</b> (Based on our representations)	Lowest year	1.6	10%	66%
	Average	1.6	11%	65%
<b>High Interest</b>	Lowest year	1.5	10%	66%
	Average	1.6	11%	65%
<b>Overspend on Treatment Works Capex</b>	Lowest year	1.5	10%	68%
	Average	1.6	10%	67%
<b>Lower WACC</b>	Lowest year	1.4	10%	67%
	Average	1.4	10%	66%
<b>Extreme Weather Event</b>	Lowest year	1.5	10%	66%
	Average	1.6	11%	65%
<b>ODI Penalty</b>	Lowest year	1.2	9%	67%
	Average	1.5	10%	65%
<b>Combined Scenario</b>	Lowest year	0.9	8%	71%
	Average	1.3	9%	69%

We also reviewed your assumption of the level of penalty exposure to the ODIs that might result from your performance against the targets Ofwat set at draft determination. We observed that your P10/P50/P90 analysis appears to be consistent with the outputs of your Monte Carlo modelling and this analysis infers the potential for the ODI for Compliance Risk Index (CRI) to be disproportionately punitive for SSC.

During our assurance activity we reviewed your developing supporting narrative. This appeared to be consistent with the outcomes of your then current assumptions, modelling and analysis. We note your commitment to ensure your final supporting narrative is consistent with the final outcome of your financial modelling, the financeability assessment, and your Monte Carlo & P10/P50/P90 analysis.

### 3.2 Material observations

There are no material observations.

### 3.3 Non-material observations

You have run a modelling sensitivity scenario, under Ofwat's notional structure, that includes an uplift to the cost of debt and consequently an uplift to the WACC.

You referred to Ofwat's draft determination modelling of Portsmouth Water. Ofwat's modelling of Portsmouth assumes an update to the WACC, driven by an uplift to the assumed cost of debt. However, Ofwat has used the nominal interest rate reflecting the uplift but the real cost of debt for Index Linked (IL) Debt has not been uplifted. Initially you followed this approach.

Subsequently you ran a sensitivity scenario that included an uplift to the real cost debt for IL debt, to determine the impact on Financial Indicators. This impact appears to have an immaterial impact on the financial indicators.

## 4. Conclusions

The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statements and the specific guidance provided in Ofwat's financial model. The team also demonstrated that your financial model input data, and your assumptions, reflect your agreed policy decisions in response to Ofwat's Draft Determination. We understand that you have fully discussed these issues at SSC Board

Your financial modelling, based on your DD representation, produces financial indicators under both the Ofwat notional and your actual capital structure, that, are consistent with your target credit rating.

Under the WACC stress test scenario your financial modelling under your actual capital structure produces financial ratios potentially too weak to support your target credit rating and under a combination of scenarios, potentially too weak to support a credit rating that is investment grade.

We observed that your P10/P50/P90 analysis appears to be consistent with the outputs of your Monte Carlo modelling and this analysis infers the potential for the ODI for Compliance Risk Index (CRI) to be disproportionately punitive for SSC

We reviewed your developing narrative, which at that time, was consistent with the outcomes of your assumptions, modelling and analysis. We note your commitment to ensure your final supporting narrative is consistent with the final outcome of your financial modelling, the financeability assessment., and your Monte Carlo & P10/P50/P90 analysis.

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 statements and the specific guidance provided in the latest version of Ofwat's financial model;
- your financial modelling reflects the decisions of your Board in relation to credit quality, in response to Ofwat's Draft Determination; and
- your P10/P50/P90 analysis appears to be consistent with the outputs of your Monte Carlo modelling.