



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

Project No: B2342800
Document Title: PR19 assurance - financeability, risk and reward
Document No.: -
Revision: Final
Date: 29 August 2019
Client Name: South Staffordshire and Cambridge Water
Client No:
Project Manager: Alexandra Martin
Author: David Russell

Jacobs U.K. Limited

7th Floor, 2 Colmore Square
38 Colmore Circus, Queensway
Birmingham, B4 6BN
United Kingdom
T +44 (0)121 237 4000
F +44 (0)121 237 4001
www.jacobs.com

© Copyright 2018 Jacobs U.K. Limited. The concepts and information contained in this document are the property of Jacobs. Use or copying of this document in whole or in part without the written permission of Jacobs constitutes an infringement of copyright.

Limitation: This document has been prepared on behalf of, and for the exclusive use of Jacobs' client, and is subject to, and issued in accordance with, the provisions of the contract between Jacobs and the client. Jacobs accepts no liability or responsibility whatsoever for, or in respect of, any use of, or reliance upon, this document by any third party.

Contents

Letter of Assurance	3
1. Introduction	6
2. Approach	6
3. Findings	6
3.1 Overall findings	6
3.2 Material observations	7
3.3 Non-material observations	7
4. Conclusions	7

Letter of Assurance

Attention: SCC Board
CC: Heather Richardson

29th 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)

0121 237 4000

alexandra.martin@jacobs.com

Important note about your report

This document has been prepared by a division, subsidiary or affiliate of Jacobs U.K. Limited ("Jacobs") in its professional capacity as consultants in accordance with the terms and conditions of Jacobs' contract with the commissioning party (the "Client"). Regard should be had to those terms and conditions when considering and/or placing any reliance on this document. No part of this document may be copied or reproduced by any means without prior written permission from Jacobs. If you have received this document in error, please destroy all copies in your possession or control and notify Jacobs.

Any advice, opinions, or recommendations within this document (a) should be read and relied upon only in the context of the document as a whole; (b) do not, in any way, purport to include any manner of legal advice or opinion; (c) are based upon the information made available to Jacobs at the date of this document and using a sample of information since an audit is conducted during a finite period of time and with finite resources. No liability is accepted by Jacobs for any use of this document, other than for the purposes for which it was originally prepared and provided.

This document has been prepared for the exclusive use of the Client and unless otherwise agreed in writing by Jacobs, no other party may use, make use of or rely on the contents of this document. Should the Client wish to release this document to a third party, Jacobs may, at its discretion, agree to such release provided that (a) Jacobs' written agreement is obtained prior to such release; and (b) by release of the document to the third party, that third party does not acquire any rights, contractual or otherwise, whatsoever against Jacobs and Jacobs, accordingly, assume no duties, liabilities or obligations to that third party; and (c) Jacobs accepts no responsibility for any loss or damage incurred by the Client or for any conflict of Jacobs' interests arising out of the Client's release of this document to the third party.

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
Base Case (Based on our representations)	Lowest year	1.6	10%	66%
	Average	1.6	11%	65%
High Interest	Lowest year	1.5	10%	66%
	Average	1.6	11%	65%
Overspend on Treatment Works Capex	Lowest year	1.5	10%	68%
	Average	1.6	10%	67%
Lower WACC	Lowest year	1.4	10%	67%
	Average	1.4	10%	66%
Extreme Weather Event	Lowest year	1.5	10%	66%
	Average	1.6	11%	65%
ODI Penalty	Lowest year	1.2	9%	67%
	Average	1.5	10%	65%
Combined Scenario	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.