Draft Determination Representations

WSH.DD.RR.2

PAYG and RCV run off rate

30 August 2019

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PAYG and RCV run off rates

1. Draft Determination adjustments to natural PAYG rates

Our approach to PAYG rates is to recover in each year an amount equivalent to operating costs.

Ofwat have accepted this approach and intervened to amend the PAYG in the Draft Determination to account for changes to the allocation of grant and contributions between Opex and Capex which had not been taken into account in the rate applied to our April Business Plan.

Ofwat also state that they have amended the PAYG rate for their view of the mix of operating and capital expenditure following their totex interventions. We do not agree with the split between opex and capex applied to the totex removed from our plan. This document set out how Ofwat should have approached this for the Draft Determination and how changes should be made for the Final Determination.

1.1. How Ofwat have determined the natural PAYG rate in the Draft Determination

Aside from a few specific adjustments, Ofwat have largely applied the ratio of Opex to Totex in total to the totex removed from our plan by price control. In effect assuming that the totex removed has the same mix of opex and capex as the company's business plan.

This approach does not take account of the differing proportions of opex and capex with the company's base and enhancement expenditure when considered separately.

Table 1 - Opex as a percentage of totex by price control in our April Business Plan

	Base	Enhancement	Third party	Totex
Water resources	84.0%	0.6%	78.7%	51.7%
Water network	59.4%	0.1%	100.0%	40.5%
Wastewater network	60.3%	0.6%	100.0%	45.2%
Bioresources	63.8%	5.8%		60.3%

Ofwat's approach assumes that the proportion of opex to totex in the draft determination allowed expenditure is broadly unchanged from the proportions shown in the final column in table 1 above.

However, £472 million of the £509 million, some 93%, of the totex difference between our April business plan and the Draft Determination is enhancement expenditure.

Table 2- Base, enhancement and totex challenged in the Draft Determination, £ million, 2017-18 CPIH deflated prices

	Base	Enhancement	Third party	Totex
Water resources	0.2	11.4	-	11.6
Water network	-	-341.5	-	-341.5
Wastewater network	-78.4	-142.4	-	-220.8
Bioresources	41.4	0.1	-	41.5
Total	-36.8	-472.4	-	-509.2

As shown by table 1 the proportion of opex to totex for our planned enhancement expenditure is significantly lower that for expenditure when considered as a whole. Therefore Ofwat's approach significantly misstates the opex and capex mix of the expenditure removed from the business plan.

1.2. How Ofwat should have adjusted opex and capex for Draft Determinations

Ofwat should consider base and enhancement separately when adjusting the PAYG rate back to a natural level in line with our stated approach of recovering an amount equal to operating costs in each year.

Maintaining the company's business plan proportions of opex and capex separately results in a significant difference to the PAYG rate by price control than Ofwat has allowed in the Draft Determination.

Ofwat should have derived the opex and capex for financial modelling and calculating the natural PAYG rate for the draft determination by multiplying the proportion of opex as a percentage of totex in the company's April business plan separately for base, enhancement and third party cost (as shown in Table 3), by the allowed expenditure in Table 4 (taken from Table 3.2 PR19 draft determination: Dŵr Cymru draft determination). The resulting opex and capex expenditure for financial modelling shown in table 5. Table 6 shows Ofwat's view and our view of the natural PAYG rate (before financeability adjustments) implied by the expenditure in the Draft Determination.

Table 3 - Opex as a percentage of totex in our April business plan

	Water resources	Water network	Wastewater network	Bioresources
Base Opex/Totex	84.0%	59.4%	60.3%	63.8%
Enhancement Opex/Totex	0.6%	0.1%	0.6%	5.8%
Third Party Opex /Totex	78.7%	100.0%	100.0%	0.0%

Table 4 – Allowed expenditure (Table 3.2 PR19 draft determination: Dŵr Cymru draft determination) £ million 2017-18 CPIH deflated prices

	Water resources	Water network	Wastewater network	Bioresources	Total
Base	155.3	939.4	1004.3	160.1	2259.1
Enhancement	132.9	112.4	224.5	7.3	477.1
Third party	45.7	9.6	1.0	0.0	56.2
Total - excluding pension deficit recovery	**333.9**	**1061.4**	**1229.8**	**167.4**	**2792.4**

Table 5 - Our view of the Opex and Capex split of totex by wholesale price control in the draft determination, 2020-25 (£ million 2017-18 CPIH deflated prices)

	Water resources	Water network	Wastewater network	Bioresources	Total
Base Opex	130.4	558.4	605.3	102.1	1396.3
Base Capex	24.9	381.0	399.0	58.0	862.8
Base expenditure	155.3	939.4	1004.3	160.1	2259.1
Enhancement opex	0.7	0.1	1.3	0.4	2.6
Enhancement capex	132.2	112.3	223.2	6.9	474.5
Enhancement	132.9	112.4	224.5	7.3	477.1
Third party opex	35.9	9.6	1.0	0.0	46.5
Third party capex	9.7	0.0	0.0	0.0	9.7
Third party totex	45.7	9.6	1.0	0.0	56.2
Total opex	167.1	568.1	607.7	102.5	1445.4
Total capex	166.8	493.3	622.1	64.9	1347.0
Totex excluding pension deficit recovery	**333.9**	**1061.4**	**1229.8**	**167.4**	**2792.4**

Table 6 – Natural PAYG rates for our Draft Determination

Natural PAYG rate	Ofwat view	Company view
Water resources	51.68%	61.17%
Water network	42.46%	53.94%
Wastewater network	46.81%	51.25%
Bioresources	60.35%	61.17%

1.3. How Ofwat should treat opex and capex and calculate natural PAYG rates for Final Determinations

For Final Determinations, Ofwat should adopt this approach explained in section 1.2 to derive operating and capital expenditure from allowed cost for financial modelling and for calculating the natural PAYG rate.

The opex as a percentage of totex (table 3 above) should be updated to reflect the changes in expenditure, for our August business plan as shown in table 7 below.

Table 7 - Opex as a percentage of totex in our August business plan

	Water resources	Water network	Wastewater network	Bioresources
Base Opex/Totex	89.4%	64.3%	65.2%	64.3%
Enhancement Opex/Totex	0.5%	0.2%	0.7%	5.9%
Third Party Opex /Totex	78.7%	100.0%	100.0%	0.0%

2. PAYG financeability adjustments

Ofwat intervened to increase PAYG rates by 3.4% for both the water and wastewater network plus controls to address a financeability constraint in the notional company. We agree that the Draft Determination is not financeable without making adjustments to the regulatory levers.

As described in section 3 we have increased the RCV run off rates in our August business plan to address financeability of the notional company. Adjusting the RCV run off rate alone was insufficient to address the financeability of the notional company. Our August business plan also includes increases above the natural PAYG rates to address financeability issues in the notional company. Specifically to solve the AICR to 1.5x.

Water Resources PAYG rates August plan

	2020-21	2021-22	2022-23	2023-24	2024-25
Natural PAYG	54.1%	48.6%	52.1%	55.7%	63.7%
Financeability adjustment	1.8%	1.6%	1.7%	1.9%	2.1%
Total PAYG rate	55.9%	50.2%	53.8%	57.6%	65.8%

Water Network PAYG rates August plan

	2020-21	2021-22	2022-23	2023-24	2024-25
Natural PAYG	48.2%	47.0%	48.1%	48.9%	50.0%
Financeability adjustment	1.6%	1.6%	1.6%	1.6%	1.7%
Total PAYG rate	49.8%	48.6%	49.7%	50.6%	51.6%

Wastewater Network PAYG rates August plan

	2020-21	2021-22	2022-23	2023-24	2024-25
Natural PAYG	41.4%	53.8%	52.2%	53.0%	53.3%
Financeability adjustment	6.5%	2.0%	1.8%	2.6%	2.5%
Total PAYG rate	47.9%	55.7%	54.0%	55.6%	55.7%

Bioresources PAYG rates August plan

	2020-21	2021-22	2022-23	2023-24	2024-25
Natural PAYG	59.53%	60.43%	60.10%	61.04%	63.69%
Financeability adjustment	1.98%	2.02%	2.00%	2.04%	2.12%
Total PAYG rate	61.51%	62.45%	62.10%	63.08%	65.81%

Draft Determination Representations document PR19 WSH.DD. RR.1 The financing of functions: WACC and Financeability] sets out our financeability assessment of the draft determination and our August business plan.

3. RCV run off rates

We set our RCV run off rates for PR19 based on the engineering lives of the underlying assets which are then weighted using the gross MEAV. Analysis performed for the company by Jacobs (IAP document B2.WSH.RR.A4 RCV Run-off Rates Methodology) demonstrates that there are a range of appropriate RCV off rates for each price control derived from the data relating to the underlying asset base.

In our response to the IAP we indicated that in the event of any further change to WACC, we would need to consider whether a consequent change was needed to our RCV run-off rate, within the range of values supported by the underlying asset lives in the business, in order to preserve the financeability of the company and protect the interest of customers.

Ofwat reduced the Wholesale WACC for Draft Determinations to 5.14% from their early view of 5.37%. We have reflected this change in the RCV-run off rates used in our August business plan, increasing the average rate across the wholesale price controls by 23 basis points from 3.52% to 3.75%. Without this change, offsetting the reduction in the WACC with an increase in the RCV run off rates, the business plan would not be financeable.

The resulting overall RCV run off rate remains amongst the lowest in the sector and the rate for each price control sits within the ranges implied by Jacobs' assessment of our asset data.

<u>RCV run off rates changes</u>

	Water resources	Water network plus	Wastewater network plus	Bioresources	Weighted average
April plan RCV run off rate	3.45%	4.08%	3.09%	6.22%	3.52%
Adjustment to RCV run off rate	0.25%	0.29%	0.22%	0.00%	0.23%
August plan RCV run off rate	3.70%	4.37%	3.31%	6.22%	3.75%

4. Appropriate use of PAYG and RCV run off

Ofwat maintain that the use of PAYG and RCV run-off are appropriate mechanisms to maintain financeability in the notional company where:

- it does not lead to a material depletion of the RCV, and
- where there is sufficient evidence of customer support for the resulting bill profile.

We have tested our PAYG and RCV-run off rate financeability adjustments against both criteria and deem that they do not lead to a material depletion of the RCV and that there is sufficient evidence of customer support for the resulting bill profile.

4.1. RCV growth

The table below shows the RCV growth in our April business plan, Ofwat's draft determination and our August plan.

	Opening RCV 2017-18 prices	2025 RCV 2017-18 prices	RCV growth
April plan	5,629	6,375	13.25%
Draft determination	5,654	6,065	7.3%
August plan	5,685	6,082	7.0%

4.2. Customer bills

The table shows the change in customer bills of the 2020-2025 period in profile (2017-18 CPIH deflated prices)

	2019-20 £	2020-25 £	Bill reduction %	Average bill 2020-25 £
April plan	439	418	5%	418
Draft determination	439	378	16%	378
August plan	439	413	6%	418

In June and July 2018, we commissioned Blue Marble to undertake customer research on the overall acceptability and affordability of our PR19 Business Plan. The research found that:

- 93% of household customers found our overall plan (bills and performance commitments) acceptable.
- 95% of household customers found the proposed bills affordable, although 30% thought it would be a 'stretch'.
- Nearly everyone across all groups say they could afford the bill for the Business Plan (including those who say it would be a stretch).

The average bill over the period in our August business plan remains unchanged from our April plan, which customers found acceptable and affordable.