



PR19 IA Assurance

Hafren Dyfrdwy

PR19 assurance - financeability, risk and reward

28 March 2019

Final



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Letter of Assurance

Attention: HD Board
CC: Heather Richardson

To the Board

PR19 Response to Ofwat's Initial Assessment – financeability, risk and reward Assurance

On 31 January 2019, Ofwat published its initial assessment of water companies' business plans for 2020 – 2025.

Ofwat challenged the HD business plan in several areas. This memo refers to the specific Ofwat challenges relating to:

- bill profiles and acceptability; and
- risk and return

Ofwat's initial assessment included specific actions required of HD.

You subsequently asked Jacobs to review Hafren Dyfrdwy intended responses.

Scope of the work

Jacobs provided support and process advice on a range of financeability related areas including:

- financial model (inputs & outputs)
- financeability assessment (ratios level and inferred credit quality)
- RCV run-off and PAYG rates including consideration of the multi-AMP perspective & bill profiles

Jacobs also reviewed your updated financeability and affordability chapters against Ofwat's requested actions.

Any statement about whether your, chosen bill profile is appropriate and the plan is financeable is the preserve of your Board, and out of scope

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 (including clarifications provided in its Initial Assessment documents) and the specific guidance provided in the latest version of Ofwat's financial model;**
- **your modelling reflects the decisions of your Board in relation to bill profiles and credit quality; and**
- **your final commentaries will be consistent with the outcome of your financial modelling, and address the feedback provided by Ofwat in its initial assessment of your September 2018 business plan.**

Conclusion

The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statement 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.

The changes you have implemented for this version of your business plan appear to result in financial ratios consistent with your target credit rating. You are satisfied that bills that are consistent with your views on customer acceptance.

We consider your narrative is consistent with your modelling assumptions and the subsequent outputs from that modelling. In addition, we observed that you have responded to the feedback and specific actions Ofwat provided in its Initial Assessment of your September plan.

We understand that you have fully discussed these assumptions at Hafren Dyfrdwy Board.

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

Yours sincerely

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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 ratios.

On 31 January 2019, Ofwat published its initial assessment of water companies’ business plans for 2020 – 2025. Ofwat challenged the Hafren Dyfrdwy’s business plan in several areas. This memo refers to the specific Ofwat challenges relating to:

- bill profiles and acceptability; and
- risk and return

Ofwat’s initial assessment included specific actions required of Hafren Dyfrdwy. You subsequently asked Jacobs to review Hafren Dyfrdwy’s intended responses.

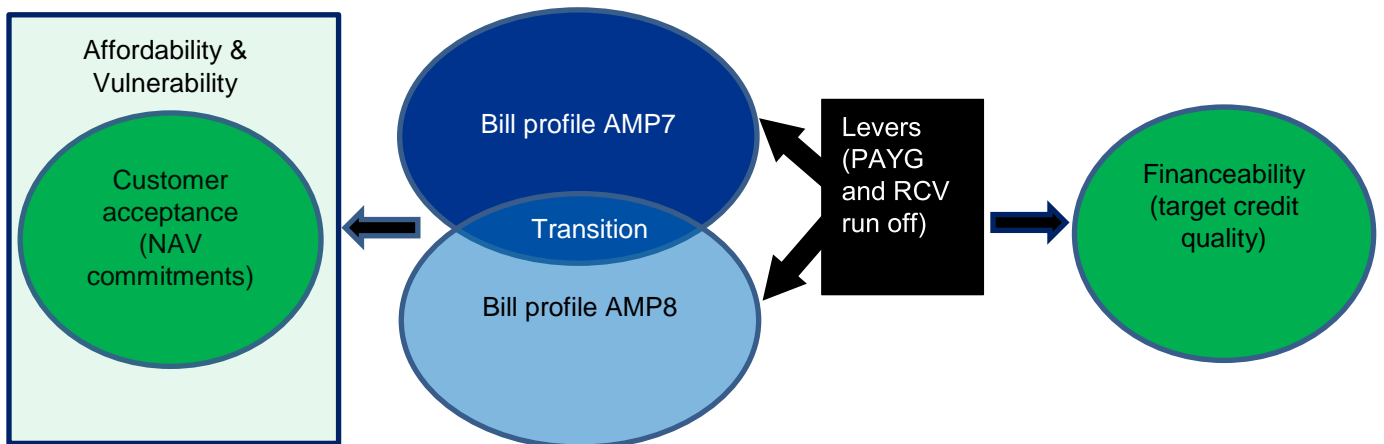
2. Approach

We agreed prior to commencing this task that the scope would cover the following key elements (see also figure 1 below):

- the key assumptions underpinning your Boards decisions on bill profiles and credit quality;
- your subsequent modeling processes;
- the financial model outputs and your interpretation of their implications for credit quality; and
- the consequential narrative on Bills profiles and risk and return.

Ofwat’s Initial Assessment feedback was presented by Business plan elements and themes. But the issues Ofwat raised are inter-related. There is tension between these elements ie they need to be calibrated balanced. – see Figure 1 below.

Figure 1



Jacobs did not assure the Business Plan submitted by Hafren Dyfrdwy September 2018, so we focused on the changes Hafren Dyfrdwy has made to its business plan in response to Ofwat's initial assessment of the Bill profile and risk and reward elements of its plan. Consistent with our other assurance work for you, we agreed we would take a risk-based approach to reviewing the above.

Our assurance was based on challenging your assumptions, modelling outcomes and the associated narrative.

3. Findings

3.1 Overall findings

We worked closely with your financial modelling team in a constructive and collegiate manner. The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statement 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.

We consider your narrative is consistent with your modelling assumptions and the subsequent outputs from that modelling. In addition, your narrative also needs to address the feedback and specific actions Ofwat provided in its Initial Assessment of your September plan. We observed that all the issues were addressed – see annex A.

Your assumptions align with your agreed policy decisions. We understand that these assumptions have been fully discussed at Hafren Dyfrdwy Board.

3.2 Material observations

There are no material observations.

3.3 Non-material observations

We recognise the context in which you have written the bill profile and risk and reward elements of your revised business plan. Ofwat has not been very prescriptive in terms of the information or action required by Hafren Dyfrdwy to address the issues raised in Ofwat's Initial Assessment of the your September business plan. Additionally, some of the Ofwat challenges do not seem to recognise the constraints resulting from the NAV commitments. Consequently, you have provided a large volume of narrative designed to ensure you have addressed all of Ofwat's concerns. We understand you are providing a table that signposts which documents seek to address each specific action on Ofwat's Initial assessment. This is a useful aid to the reader.

We recommend that this a table could be supported with;

- a few succinct key messages relating your chosen bill profile; the constraints of the NAV; and the consequential financial ratios and inferred credit quality; and
- flags to indicate where you are maintaining your September Business Plan position and providing further evidence vs making changes and proving associated rationale.

4. Conclusions

We worked closely with your financial modelling team in a constructive and collegiate manner. The team demonstrated that, when running Ofwat's financial model, it followed the general guidance in Ofwat's PR19 methodology statement 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. We understand that you have fully discussed these assumptions at Hafren Dyfrdwy Board.

We consider your narrative is consistent with your modelling assumptions and the subsequent outputs from that modelling. In addition, we observed that your addresses the feedback and specific actions Ofwat provided in its Initial Assessment of your September plan. You have included signposting to the Ofwat issues addressed in your narrative and a summary of the key elements of your approach, both of which are helpful to the reader

Annex A

Tables 1 -3 shows sign post where Jacobs recognise you have sought to address Ofwat's specific Initial Assessment queries

Table 1- key drivers of bill profiles and credit quality

Table 1	Summary	Document reference
Long term bill profile - with customer acceptance [HDD.AV.1 – HDD.AV.3 & HDD.RR.A8]	In line with customer acceptability and NAV commitments	8.1.1, 8.1.5, 8.1.6, 8.1.7
Target credit rating [HDD.RR.A4]	Ratios support rating if at least BBB+ target	8.2.2
PAYG adjustments [HDD.RR.A7]	Support Bill profile acceptable to customers	8.1.2, 8.1.3

Table 2- technical issues

Table 2	Summary	Document reference
Level of cross subsidy for Social Tariffs [HDD.AV.A4]	Remove from scope. Contained in a different chapter of the plan.	N/A
1.20 % for <5ml/y users [HDD.RR.A1]	Justified as a uniform mark up on cost, overall margin on ineligible customers =1%	8.2.3
RoRE Variance [HDD.RR.A2]	Looked at revenue variance component and adjusted down based on Revenue Forecast Incentive (RFI) changes	8.2.4
Stress test beyond 2025 [HDD.LR.A4]	Tested	8.2.2
Risk management and risk mitigation [HDD.RR.B1]	Financial metrics are robust, in spite of accounting losses, risks manageable	8.2.2
Starting point for RCV run off and PAYG rates [HDD.RR.A6]	<ul style="list-style-type: none"> NAV means "natural rate" is not relevant So looked at alternatives and their impact 	8.1.2, 8.1.3
Gearing benefits sharing mechanism [HDD.CA.A2]	Committed to implementing the default mechanism	10.3.1
Dividend policy [HDD.CA.A3]	Committed to adopting the "back in balance" expectations	10.3.2
Executive pay [HDD.CA.A4]	Full disclosure, linkage to customer delivery, targets, reporting	10.3.3

Table 3 - Data and modelling

Table 3	Summary	Document reference
PR14 reconciliations [HDD.PD.A1-6]	HDD.PD.A5 – Changes to totex models necessary due to NAV as we can't re-open PR14	9.2.1
Revised tables [HDD. CA.A5 – HDD.CA. A8]	Revised tables will be provided	Tables
Financial model [HDD.CA.B1]	Pensions and fixed assets issues addressed (CA9.6). Ofwat has now clarified the way in which the appointee dividend is to be split between retail and wholesale.	Model