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South Staffs Water

incorporating



Board assurance of our PR19 business plan

South Staffs Water
(incorporating Cambridge Water)



Board assurance statement

The Board considers all the elements add up to a business plan that is high quality and deliverable

The Board of South Staffs Water owns and is fully accountable for the business plan that we are putting forward. We are able to provide to Ofwat and our customers and stakeholders comprehensive and robust assurance due in part to our scrutiny of the business plan being put forward but more importantly because we have been actively involved in its creation from the beginning and have challenged throughout its evolution. We believe that there have been some particular points where our input has been invaluable in shaping the plan we now submit:

From the outset our aim was to produce a business plan that was rooted in a genuine understanding of customer needs and also was innovative and ambitious. With this in mind we have mandated a substantial investment in a comprehensive and multi-faceted customer engagement programme. We have reviewed the outputs from this programme carefully and we have observed a number of the focus groups over the last two years. The plan reflects our customers' views and they have helped us create it.

The Board initiated an exercise to review the company's comparative performance in the industry across a number of key service measures as well as our cost efficiency. This led to the aspiration that we would put forward a plan that would place us as leaders in the industry on performance measures that matter most to customers. The package of performance commitments we are putting forward reflects customer priorities and we believe is very ambitious.

Despite there being a challenging environment we are planning to invest substantially more than we have historically and in particular to overhaul our two major treatment works, Seedy Mill and Hampton Loade, to create clear water quality and resilience benefits for customers. We have carefully considered a wide range of options and sought advice from a variety of leading experts and the resulting cost adjustment claim has the strong support of our customers.

We have also taken time to consider many different approaches to the challenges we face. We have considered new technologies, different ways of working, ideas from other parts of the world and feedback from our own team. The plan we are putting forward is innovative and we believe it will help to move the sector forward in a number of areas benefitting customers beyond our geographical monopoly areas.

We have also considered our customers who are vulnerable and made special provision for them both economically but also through a tailored support package. We know that this is not the most economically efficient approach but it is the right approach for a public service provider with a universal service obligation to take.

Finally, we have carefully considered the financeability of our plans. It is true to say that, given the scale of our ambition, the lower returns and our level of long term embedded debt, this has been a real challenge. We have debated at length the merits of seeking a company specific cost of capital adjustment and concluded on balance that we propose to adopt the Ofwat cost of capital from December 2017 and that in the round this is in our customers' interests.

We have also considered some specific areas in providing our assurance.

Resilience

We have considered the approach taken to ensure that resilience will be managed in the interest of customers for the long term. At an early stage the Board saw an innovative approach to modelling resilience (our 'resilience lens') and this became embedded within our process for choosing the best investment options for our customers and our business.

We have also reviewed in detail our financial resilience in delivering our plan. As part of our annual reporting, we assessed the long term viability of the company based on our business plan projections. Based on the financial projections, the stress tests performed and the mitigations considered, we declared that the company is financially resilient for at least the seven years to 2025. Our assessment of the financial resilience for the business plan is consistent with this.

Earning customers' trust

Recognising we are a public service provider, we recognise the importance of being transparent with our customers on corporate and financial structures. We need to measure that trust.

As part of our engagement with customers we proposed a performance commitment in relation to trust based on customer surveys carried out by us and by CCWater. We have also committed to being open and transparent through our website and our annual reporting. Our Annual Performance Report sets out in detail our group structure, our Board and governance arrangements and our approach to executive pay. We also recognise the importance of Ofwat's position statement on 'putting the sector back in balance' and have ensured that the specific points are appropriately covered in our plan.

Meeting statutory and licence obligations

We have a number of statutory and regulatory obligations as a Water Undertaker. These obligations are predominantly set down in the Water Industry Act 1991 and our Instrument of Appointment (the 'Licence'). Each year the Board considers its obligations as a water undertaker and that we understand and comply with them. The Board believes that these ongoing statutory and licence obligations will still be met in the future as we deliver our business plan.

As part of the business planning process, the Board have also considered whether our plan will ensure that we will also meet new specific obligations set out in the Water Industry Strategic Environmental Requirements (WISER) document. In June 2018, the EA asked companies to provide assurance that their business plans will include actions, investments and approaches that meet these expectations and we have been able to provide this assurance.

The Board has also ensured that the plan meets the expectations of the government's Strategic Direction Statement (SDS) in particular in the areas of resilience and protecting customers.

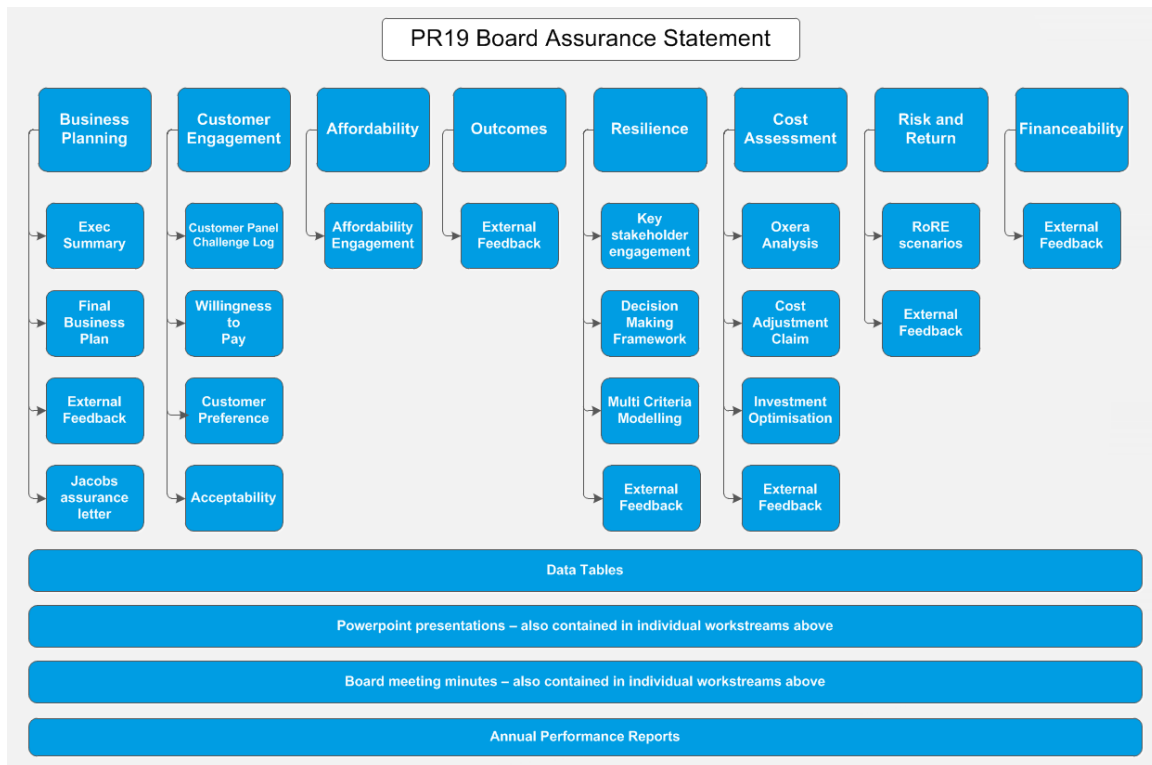
We are therefore able to provide our assurance that this plan is the right plan for our customers and we commend it to you.

Evidence of Board input and challenge

The Board has been fully involved in the development of the plan and has continually challenged management.

For the past 18 months, the Board has been presented with regular updates on proposals from presentations at the monthly Board meeting where there has been direct challenge on management. There has been a wealth of information and reports made available and as we have entered the final stages of finalising the plan, the Board has had access to a secure Sharepoint site containing a library of information to enable us to make the specific assurance statements required.

Making water count – business plan 2020/25
South Staffs Water (incorporating Cambridge Water)



Directors (including Independent Non-Executive Directors) have attended a number of quarterly independent customer panel meetings and have heard first hand feedback on the quality of the customer engagement. Members of the Board have also attended a number of customer focus groups held as we developed our plan to help ensure that our plan is consistent with customer views.

The Board has had access to both our independent internal assurance manager and external technical auditors (Jacobs) as well as other third party reports to provide further evidence of the quality of the plan. This assurance complemented the evidence base in a number of specific areas:

- Data quality.
- Strength of our investment proposals.
- Financeability, both on an actual and notional structure.
- Cost assessment modelling to confirm our view that the plan is efficient.

The Board has also been provided with additional external assurance on the overall quality of the plan by Jacobs who carried out a ‘dry run’ of Ofwat’s Initial Assessment of Plans (IAP) test.

Board assurance requirements

Below are the specific areas where the Board has provided assurance and the evidence it has considered to enable it to make such a statement.

Area: Business planning

The Board has challenged and satisfied itself that:

- all the elements add up to a business plan that is high quality and deliverable;
- the overall strategy for data assurance and governance processes delivers high-quality data;
- the business plan will enable the company to meet its statutory and licence obligations, now and in the future and take account of the UK and Welsh Government's strategic policy statements;
- the plan will deliver operational, financial and corporate resilience over the next control period and the long term through the company's governance and assurance processes, taking account of its track record of performance;
- it will enable its customers' trust and confidence through high levels of transparency and engagement with customers on issues such as its corporate and financial structures; and
- it has provided ownership of the overall strategy and direction of the plan in the long term.

Evidence

Meetings

- PR19 Board Strategy Day held on 8th March 2017. We shared strategic challenges and Customer Engagement Plan. (Presentation available)
- Board Meeting 4th May 2017, Minute reference 2508 - High Level Themes of Ofwat's Customer Engagement Presentation.
- Board Meeting 29th June 2017 – Presentation given on PR19 Innovation Ideas – Minute Ref:2539 – (Presentation Available)
- Board Meeting 2nd August 2017 – Managing Director's report provided an update on meeting with Cathryn Ross – Innovation Ideas (retail separation, customer segmentation/service plans, Customer Dash Board)
- Board Meeting 2nd August 2017 – Ofwat published detailed Retail Methodology, and the summary was shared with the Board.
- Board Meeting 2nd August 2017 – Price Service Trade Off research paper presented (Paper available)
- Board Meeting 2nd August 2017 – Comparative Industry Performance Industry Benchmarking Report shared – Upper Quartile Challenge made by Board (Paper Available)
- Board Meeting 28th September 2017, Minute reference 2544, Chairman met with Jonson Cox – Innovations well received but challenge to Board on ambitious plan delivery).
- Board Meeting 28th September 2017, Minute reference 2545 – confirmation of the Company's ambition to pursue exceptional FastTrack plan.
- Board Meeting 28th September 2017 – Noted in the PR19 report that the Company had submitted its response to the PR19 Draft Methodology. (Paper Available)
- Board Meeting 19th October – Comparative industry performance for 9 common ODIs shared with board – scale of ambition in ODI package discussed
- Board Meeting 18th January 2018 – PR19 Board Report noted the Outline Approach to Cost Adjustment Claim. Discussion on Claim vs. Enhancement – concluded claim was appropriate

Area: Business planning

- Board Meeting 18th January 2018 – PR19 Board Report noted that Ofwat published its final mythology for PR19
- Board Meeting 19th October – MD Report Jacobs contract award
- Board Meeting 22nd February 2018 – PR19 Board Report, confirmed commissioned Costain to improve robustness of costs for WTWs. Minute reference 2608
- Board Meeting 28th March 2018 – presentation on retail strategy and proposed functional separation of retail activity from wholesale

Documentation

- Business plan narrative, against Ofwat summary
- Delivery against assurance plans, audit reports (internal and external)
- Risk and compliance statement – we believe that we already comply and have no reason to believe that the business plan would change this
- Business plan narrative, IAP test, independent assurance reports (eg, financeability)
- APR disclosures, company dashboard, dividend policy and executive performance related pay
- Evidence in Board minutes showing time taken in Board meetings to cover PR19
- Executive summary and infographics
- Defra Strategic Direction Statement
- Company submission in response to the EA's Water Industry Strategic Environment Requirements (WISER) demonstrating that we will meet our statutory obligations.

Area: Customer engagement

The company's business plan has been informed by:

- customer engagement; and
- feedback from the company's CCG about the quality of its customer engagement.

Evidence

Meetings

- June 2017 – Board members inputted into Price and Service Trade off Customer Engagement workstream in response to board challenge to seek an initial view of customers' preferences to a flat or declining bill profile
- 12th June 2017 - board member observed two Focus Groups with HH and NHH customers in Cambridge region (Foundation Research on customers' priorities). Challenged that the PR19 engagement needs to demonstrate innovation in terms of approach
- Board Meeting 2nd July 2017 – Price and Service Trade off Customer Engagement Shared
- Board Meeting 28th September 2017, Board reference 2565 - Customer Panel shared their Annual report
- Board Meeting 19th October 2017 – PR19 Board Report, Approach to Willingness to Pay Engagement shared
- Board Meeting 16th November 2017 - Customer Engagement and Insight Manager presented update on PR19 engagement strategy and key findings from customer priorities

Area: Customer engagement

research. Board challenged that the follow up WTP study should include a sample of customers seeing a lower bill profile. This challenge was confirmed as being incorporated into the follow up study

- Ofwat customer engagement meeting 24th January 2018 – attended by Managing Director
- Board Meeting 18th January 2018 update on Customer Engagement work streams provided
- Board Meeting 28th March 2018 – PR19 Board Report update on ODI Customer Engagement
- 24th April 2018 - board member observed morning session of workshop event with HH and NHH customers in Cambridge region (PC/ODI customer engagement)
- Board meeting 1st May 2018 – Customer Engagement and Insight Manager presented update on all PR19 Engagement. Board requested to see the full priority ranking of the WTP attributes tested, with a particular focus on reliability of supply options. This was circulated to the board post meeting
- Board Meeting 7th August 2018 – Proposal for a flat nominal bill presented including the overwhelming evidence of support from customers
- Board Meeting 7th August 2018 – Attendance by Chair of CCG to give feedback on the Panel’s report and their views on customer engagement
- Board Meeting 7th August 2018 – Presentation of results of customer acceptability testing

Documentation

- Response to customer panel strategic challenges
- Customer panel challenge log
- Cost adjustment claim – co-created with customers
- Performance commitments – co-created with customers
- Scope of work, outputs and dissemination slides for all engagement
- Academic peer review of WtP – approach and results
- Academic peer review of approach to triangulation
- Outputs of Customer Acceptability testing

Area: Affordability

The company’s business plan is affordable for all customers, including in the long term and including appropriate assistance for those struggling, or at risk of struggling, to pay.

Evidence

Meetings

- Board Meeting 28th June 2017 – Approval of increase in Assure social tariff from £1.50 to £3.00 following customer research.
- Board Meeting 2nd July 2017 – Price and Service Trade off Customer Engagement Shared
- Board Meeting 7th August 2018 – Presentation of results of customer affordability testing

Documentation

- Assure social tariff

Area: Affordability

- Vulnerability sub-group action logs

Area: Outcomes

The business plan will deliver – and that the Board will monitor delivery of – its outcomes and performance commitments.

The company's proposed outcomes, performance commitments and outcome delivery incentives (ODIs) reflect customer preferences and are stretching.

The company's proposed approach to reporting on its performance commitments, ODIs and projections of outcomes is robust.

Evidence

Meetings

- Board meeting on 20th January 2017 paper provided on PR19 Outcomes Framework Consultation
- Board Meeting 4th May 2017, Minute reference 2499 – Scale and Ambition of Performance Commitments discussed
- Board Meeting 28th June – latest list of ODI's and projected targets discussed
- Board Meeting 28th September 2017 – Managing Director's report, current performance on 9 common AMP7 PC's reported
- Board Meeting 19th October 2017 – scale of ambition of ODI package discussed
- Board Meeting 18th January 2018 – Paper shared development of performance commitments for AMP7
- Board Meeting 22nd February 2018 presentation of draft ODI package shared. Minute reference 2611
- Board Meeting 7th August 2018 – final ODI targets presented with agreement to target upper quartile performance in each and review of the financial rewards and penalties and resulting RoRE range

Documentation

- Evidence of customer co-creation of PCs
- Feedback on customer engagement, including WTP and acceptability testing results
- Details of how PC levels have been set in relation to forecast UQ level
- Review of plans how we will report and communicate performance 2020/25
- Annual assurance plans

Area: Resilience

The company's business plan has been informed by:

- a robust and systematic assessment of the resilience of the company's systems and services;
- customers' views about managing resilience; and

Area: Resilience

- a comprehensive and objective assessment of interventions to manage resilience in customers' long-term interests.

Evidence

Meetings

- PR19 Board Strategy Day held on 8th March 2017. We shared strategic challenges including Supply Capability Challenges
- Board Meeting 29th June 2017 – Long Term Plan Progress Update shared with Board
- Board Meeting 29th June 2017 – Presentation re PR19 and Innovation shared. Board Reference 2539
- Board Meeting 28th September 2017 – Multi criteria analysis including resilience was shared with the Board
- Board Meeting 28th September 2017 – Approval of Draft WRMP
- Board Meeting 19th October 2017, Minute reference 2555 – Approach to operational resilience included in multi criteria further explored
- Board Meeting 19th October 2017 – Managing Director's report – shared positive meeting with DWI re WTW
- Board Meeting 30th November 2017 – Draft WRMP for submission

Documentation

- Resilience lens
- Multi criteria analysis
- Multi region support for cost adjustment claim.
- Customer engagement
- Long term plan presentations/papers

Area: Cost assessment

The expenditure forecasts included in the company's business plan are robust and efficient. Large investment proposals are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers.

Evidence

Meetings

- PR19 Board Strategy Day held on 8th March 2017. We shared strategic challenges including early outputs of Long Term Plan
- Board Meeting 29th June 2017 – Long Term Plan Progress Update shared with Board
- Board Meeting 19th October 2017, Minute reference 2555 – Least cost scenarios for long term plan and associated sensitivity analysis shared
- Board Meeting 30th November 2017 – PR19 Board Report – Approach to Base Capex Programme discussed.

Area: Cost assessment

- Board Meeting 22nd February 2018 – PR19 Board Report, confirmed commissioned Costain to improve robustness of costs for WTWs. Minute reference 2608
- Board Meeting 28th March 2018 – Presentation shared on Draft AMP7 Totex position
- Board Meeting 28th March 2018 – cost adjustment claim for enhancement expenditure at Hampton Loade and Seedy Mill including the positive customer support gained
- Board Meeting 1st May 2018 - cost adjustment claim for enhancement expenditure and Hampton Loade and Seedy Mill approved
- Board meeting 28th June 2018 – Presentation on latest Totex position and comparison of Botex to Oxera modelling with conclusion that upper quartile on efficiency

Documentation

- Oxera benchmarking reports
- Jacobs review of capex optimisation
- Productivity analysis
- Efficiency analysis (KPMG presentation)
- Cost adjustment claim and Jacobs DPC review

Area: Risk and return

The Board has identified the risks associated with delivering the plan.
The risk mitigation and management plans the Board has in place are appropriate.

Evidence

Meetings

- Board Meeting 28th September 2017 – Multi criteria analysis including approach to costings was shared with the Board
- Board meeting 28th June 2018 – requirement for a cost of capital adjustment discussed and agreement not to pursue a claim
- Board meeting 7th August 2018 – RORE range discussed

Documentation

- Risk section of business plan narrative

Area: Financeability

The company's business plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in both the short and the long term. The statement should clearly set out the steps taken to provide this assurance.

Evidence

Meetings

- Board Meeting 29th June 2017 – Cost of Capital Adjustment Claim in PR19 report

Area: Financeability

- Board Meeting 2nd July 2017 – PR19 report shared Oxera’s analysis of Financeability
- Board Meeting 28th September 2017, Minute reference 2538 dialogue with RBS re embedded debt
- Board Meeting 19th October 2017 – Paper shared re embedded debt
- Board Meeting 28th June 2018 – Discussion on the merits of putting forward a specific cost of capital adjustment claim
- Board Meeting 28th June 2018 – Paper presented on the Company’s long term viability statement covering the seven years to 2025
- Board Meeting 7th August 2018 – Presentation on financeability tests on both actual and notional structure. Sensitivity analysis shared on the commitment to a flat nominal bill for AMP7

Documentation

- Jacobs’ independent assessment that the plan is financeable
- Financial resilience and review of stress testing scenarios
- Consistency with long-term viability statement

The Board provides this comprehensive assurance statement that confirms our business plan submission is both of high quality, ambitious and in accordance with the requirements of Ofwat’s PR19 methodology.

Sir James Perowne
Independent Chairman
South Staffordshire Water Plc



Keith Harris
Independent Non- Executive
South Staffordshire Water Plc



Stephen Kay
Independent Non- Executive
South Staffordshire Water Plc



Making water count – business plan 2020/25
South Staffs Water (incorporating Cambridge Water)

Adrian Page
Group Chief Executive
South Staffordshire Plc



Phil Newland
Managing Director
South Staffordshire Water Plc





SSC PR19 assurance

South Staffs Water

PR19 APR assurance letter - South Staffs Water plc

31 August 2018

Final



SSC PR19 assurance

Project No: B2342800
Document Title: PR19 APR assurance letter - South Staffs Water plc
Document No.:
Revision:
Date: 31 August 2018
Client Name: South Staffs Water
Project Manager: Andrew McGeoghan
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Letter of Assurance

For the attention of the Board

31 August 2018

PR19 assurance

As your technical assurance partner, we helped you to develop an assurance framework for your PR19 business plan. Amongst other things this identified the components of your plan you considered required external assurance. Based on the outputs from the framework, you asked us to review the following broad areas of your plan over June to mid-August 2018.

- Your overarching approach to developing your performance commitments (PCs) and the associated service levels; your approach for linking your customers' preferences to the PCs and their incentives; and the overall outcomes incentive package.
- The process you followed in the development of your totex programme; your approach to allocating totex between price controls and expenditure categories; and your wholesale water cost adjustment claim (CAC).
- Your approach to financial modelling for consistency with Ofwat's rule book and methodology, the rationale supporting some of the associated decisions (eg: use of PAYG and run off levers), and a review of your approach to overall financeability. We have provided you with a separate letter summarising the scope of our work and our findings.
- A limited number of business plan tables that you considered high risk, due to their complexity or inherent difficulties in forecasting data for them (eg: App28 Developer Services).
- Your PR14 reconciliation submission, which we assured at the same time as your annual performance reporting. We provided you with a separate report in July 2018 that detailed the scope of our work and our findings.

Consistent with the agreed scope, for the areas above our reviews and challenge focused on the consistency of your approach or proposals with Ofwat's expectations, methodology and, where applicable, business plan table guidance. In line with our normal assurance work our approach was risk-based and, in the majority of cases, our initial work was based on meetings with your teams.

As with our annual assurance, our feedback and observations focused on identifying reporting and regulatory risks. This letter summarises our observations and we have provided your teams with detailed feedback and comments.

Observations

Across the areas we reviewed, we observed your teams generally had a good understanding of Ofwat's expectations, as set out through the methodology and any supporting guidance – and that their approaches were broadly consistent with them.

During our meetings with your teams, we observed that your regulation team had been alerting data owners to relevant entries in Ofwat's PR19 methodology queries and responses documents. As the query process was an on-going process, we agreed we would not systematically check that your teams had taken account of all relevant queries.

For the areas we reviewed, we noted that your teams' proposals appeared to be based on a reasonable process. We have provided feedback on possible areas for improvement, including scope in some cases to demonstrate more clearly how proposals aligned with Ofwat's expectations. For the development of your totex programme for example, we considered you could set out more clearly where innovative solutions had been considered to help demonstrate that your optimisation had considered a wide range of options and was aligned to achieving stretching service levels.

We note that during our review of the plan areas, we have discussed some areas of risk.

- For financeability, we considered your approach to modelling appeared consistent with both Ofwat's methodology and rulebook and with your own policies and decisions. You explained that you and your Board are comfortable with your pre-legacy adjustment financial ratios, although we observed that due to your chosen bill profile these ratios display a declining trend. We also observed that financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates. We discuss our observations in relation to financeability more fully in a separate letter.
- During our review of your approach to financeability, we discussed your proposal to keep customers' bills flat in nominal terms (ie: declining by inflation in real terms). We noted that whilst Ofwat might broadly welcome this proposal, we consider it will expect you to:
 - set out how the proposal would work in practice, including setting out how it would work mechanistically with Ofwat's other incentives and how the risk of inflation turning out to be materially higher or lower than your assumptions is allocated;
 - demonstrate that you have considered the intergenerational impact of the proposal, including the potential profile of bills across regulatory periods; and
 - demonstrate how you have reflected customers' views when considering the proposed allocation of risk and intergenerational impacts.
- Following our review of your proposed CAC, we observed that you appeared to have followed a reasonable process in developing it. We recognise this is a material claim for you and observed that you have utilised third parties to help develop your case. As agreed we have not assured work completed by these third parties, though we did recommend that a third-party report on cost and optioneering is appended to your plan. When reviewing the proposed CAC submission, we consider we identified scope to enhance the evidence to support your claim, notably by including support/ a notice from the Drinking Water Inspectorate on the water quality issues you set out – and further analysis to demonstrate more clearly why these were outside your control. We also recommended you set out how you arrived at the value of the claim in more detail and clarified how customers are protected through your proposed PC.
- You explained during our review of your outcomes that the expected impact of your PC out and under performance payments on your return on regulatory equity (RoRE) was potentially inconsistent with Ofwat's expectations and customers' wider interests. We recognise that your teams had not finalised their work and recommended you review the range of inputs used for your P10/P90 RoRE analysis to ensure it was based on the full range of costs and benefits and appropriate forecast service levels.

We discussed the above areas and provided you with more detailed feedback. We understand you have reflected on these risks in finalising your business plan proposals. Consistent with the agreed scope, you managed the completion of any actions and recommendations.

Conclusion

We observed that you have implemented an assurance framework to target high risk areas of your plan and note that this derived the scope of our assurance. This reflects your internal assurance processes and was designed to build on previous assurance, such as that provided on your annual performance report (including in relation to your approach to cost allocation) and PR14 reconciliation submission.

PR19 APR assurance letter - South Staffs Water plc

We observed that your teams had worked hard in developing their approaches to the business plan areas we reviewed. Due to the constraints imposed by the PR19 programme, we note that for some of the areas we reviewed you had not fully finalised aspects of your approach. This was the case for example for your outcomes, where at the time of reviewing your approach you were still finalising: some of the proposed service levels and incentive rates; the justification for changes to the PR14 package of PCs; and the explanation of your approach to incentives, bill phasing and affordability.

Overall, we consider your teams had a good understanding of Ofwat's expectations and reporting requirements for the PR19 areas we reviewed.

A handwritten signature in black ink, appearing to read 'AMG', with a long horizontal line extending to the right.

Andrew McGeoghan
Head of Economic Regulation and Assurance

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SSC PR19 assurance

South Staffordshire Water

PR19 assurance - financeability, risk and reward

31 August 2018

Final



SSC PR19 assurance

Project No: B2342800
Document Title: PR19 assurance - financeability, risk and reward
Date: 31 August 2018
Client Name: South Staffordshire Water
Client No:
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Letter of Assurance

Attention: Board

PR19 assurance – financeability, risk and reward

Ofwat requires each company's business plan to demonstrate that:

- proposed revenues, relative to assumed costs, are sufficient for an efficient company to finance its investment and so deliver its activities, on reasonable terms, while protecting the interests of customers now and in the long term; and
- an efficient company would be able to generate cash flows sufficient to meet its financing needs (once plan components such as totex, cost of capital, PAYG and RCV run-off levers are taken into account).

Scope of the work

As agreed, our assurance focused on:

- your understanding of Ofwat's guidance;
- your documentation of policies and assumptions (such as those related to your choices over financial levers, your dividend policy etc);
- the appropriateness of your application of Ofwat's guidance (and assumptions you made) in your financial modelling;
 - on your actual capital structure;
 - on Ofwat's notional structure (including RORE scenarios); and
- the narrative supporting your assumptions and subsequent proposals.

We reviewed these areas based on the level of materiality to price limits and risk of reputational damage.

We agreed the derivation of the inputs to the financial model under the company's actual capital structure, and the downside scenarios under your actual capital structure, were out of scope. We also agreed that any statement about whether your plan is financeable is reserved for you as the Board and therefore outside our 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 statement and the specific guidance provided in Ofwat's financial model;**
- **where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions; and**
- **your final commentaries are consistent with the outcome of your financial modelling, in that they explain the key drivers of any financeability constraints and the reasons for your chosen approach.**

Conclusion

When running Ofwat's financial model you have followed the general guidance in Ofwat's PR19 methodology statement and the specific guidance provided in Ofwat's financial model. Where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions.

As part of our work we reviewed your business plan narrative, and confirmed that it was consistent with your modelling and the outputs from your modelling. As requested we provided challenge on your key modelling assumptions, for example your arguments to support: your decision not to use the financeability levers; and the level and profile of your financial ratios. We observed that your assumptions align with your agreed policy decisions and understand that you have fully discussed these assumptions as a Board.

We provided your team with feedback that set out in detail the scope of our work, the specific activities we undertook and our findings.

Yours sincerely

Nigel Sanders
Director of Operations

Important note about your report

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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.

You will need to provide evidence in your PR19 Business plan that you have used robust processes, data and information, plus appropriate strategies, to satisfy yourself that South Staffordshire Water (the Company) remains financeable at appointee level.

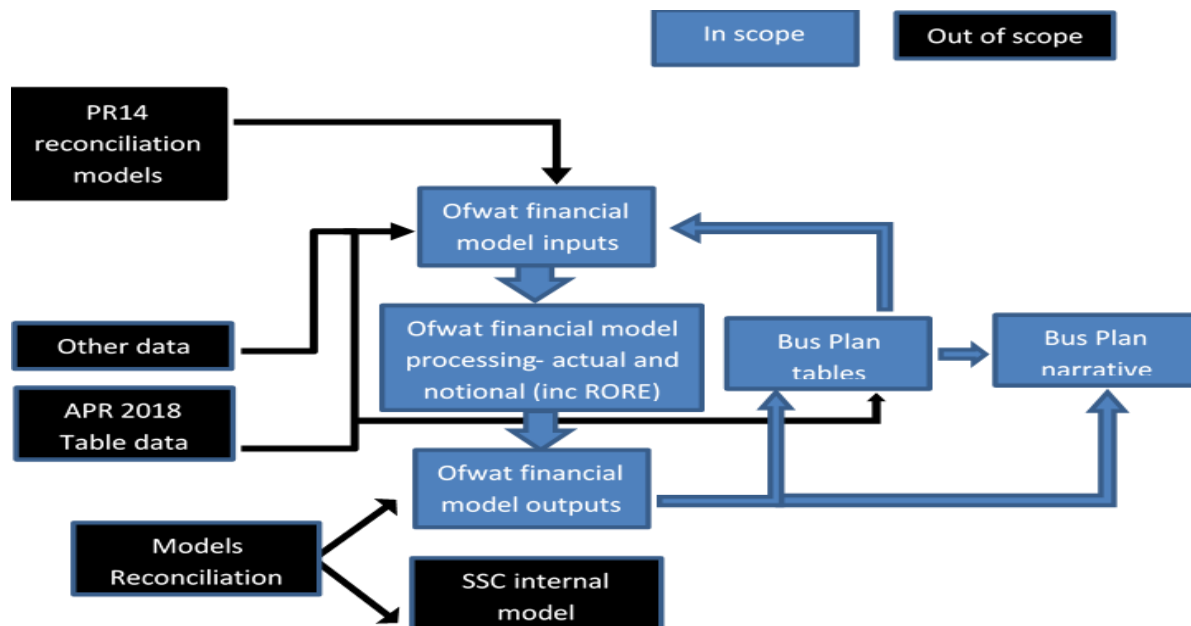
In addition, Ofwat expects companies to align the interests of companies and their investors with those of their customers. Therefore, you will need to make an assessment of the balance between risk and return in your plan, ensuring it is compatible with the Company’s risk appetite. One of the ways Ofwat expects you to assess this is by using return on regulated equity (RoRE) modelling to assess the potential range of risk and return exposure.

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 data inputs;
- your modeling processes;
- the financial model outputs; and
- the consequential commentary on key assumptions the financial model and outputs.

Figure 1 Elements of the financeability that were in and out of scope



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 teams' processes, data and assumptions via a combination of:

- face to face meetings (using live active versions of Ofwat's financial model); and
- desk top reviews.

We agreed the following components were out of scope:

- derivation of the inputs to the financial model under the company's actual capital structure; and
- downside scenarios under your actual capital structure.

We note this data was subject to your own internal assurance processes.

We also agreed that any statement about whether your plan is financeable is the preserve of your Board and therefore outside our scope.

3. Findings

3.1 Overall findings

We worked closely with your financial modelling team in a constructive and collegiate manner. Any material issues identified during the assurance process were subsequently resolved to your team's satisfaction. 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. There are a limited number of instances where Ofwat's guidance lacks prescription or is open to interpretation. In these instances, you have made what appear to be reasonable assumptions.

The financial modelling is naturally a back ended process, subject to a number of iterations as policy decisions and the associated data key inputs are locked down. The completion of Jacobs's assurance process has been iterative and back end loaded too. Consequently, there is inevitably some risk of inconsistency in data between the business plan tables and Ofwat's financial model, but this should be mitigated by use of your internal assurance functions.

The team also demonstrated that your financial model input data, and your assumptions, reflect your agreed policy decisions and we understand that these assumptions have been fully discussed at SSC Board. We have observed that due to your chosen bill profile these ratios display a declining trend. We also observed that financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

We consider your narrative is consistent with your modelling assumptions and the subsequent outputs from that modelling.

3.2 Material observations

There are no material observations.

3.3 Non-material observations

In addition to the overall findings noted above, we also note the following non-material observations.

Financial modelling - actual structure: base case

You are proposing a profile of flat nominal bills over the period 2020-2025. Consequently, financial ratios weaken over the period as costs inflate. Average financial ratios over the period 2020-2025 are consistent with your current and target credit ratings but there is a risk that the declining trend might be of concern to the rating agencies and therefore to Ofwat too. However, you have mitigated this risk by explaining in your narrative that the volume and profile of expenditure in the period 2020-2025 is atypical. You are clear that you have also modelled projections from 2025 to 2030 to illustrate how financial ratios will recover over the longer term.

Notional Structure Modeling

The Ofwat financial model includes an overwrite tab that facilitates the notionalisation of a company's financial structure and financial costs, namely:

- capital structure;
- cost of capital - appointee and wholesale;
- debt real fixed;
- debt nominal fixed;
- debt nominal floating;
- share structure;
- shareholder distribution; and
- retail margin

Ofwat's financial model also includes a tab providing guidance on how to complete the required data inputs. In a limited number of instances, the guidance lacks prescription. Where this is the case, we consider you appear to have made reasonable and logical assumptions.

- You have assumed 70% of the real Cost of equity is distributed to shareholders via a dividend (dividend yield) and the remaining 30% is annual real dividend growth. Your approach is consistent with both corporate finance theory and Ofwat's assumption at PR14
- Real rate of interest on index linked debt – you have assumed financial year average RPI as you consider that this best reflects the fact the Index linked debt instruments can be inked to RPI at varying points in the year

Your original retail balance sheet included an amount of cash. To achieve the Ofwat prescribed notional gearing for the appointee. You moved this cash to the wholesale balance sheet. Consequently, the retail balance sheet does not balance. We note Ofwat might choose to standardise these assumptions across all companies when undertaking its notional modelling. You consider the impact of any divergence from your assumptions is likely to have no material impact on the revenue requirement or the resulting financial ratios.

Your financial ratios are weaker compared to those modelled on your actual structure. We consider this position reinforces our recommendation that you seek additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

Legacy adjustments

You have followed Ofwat's guidance and presented your financial ratios prior to any legacy adjustments. However, we have observed that your ratios will marginally improve when legacy adjustments are applied, presuming you are able to get the desired outcome from Ofwat in relation to your developer revenue PR14 reconciliation.

RORE sensitivities

Ofwat prescribed a number of scenarios that should be modelled to establish potential RORE ranges. We sample checked your calculation of the required input data. You appear to have followed the Ofwat guidance and where guidance lacks prescription or is open to interpretation, you have made what appear to be reasonable and defensible assumptions.

You consider there to be some inaccuracies in the RORE ranges produced by Ofwat's financial model. You have informed us that you will include relevant commentary in your business plan.

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. There are a limited number of instances where Ofwat's guidance lacks prescription or is open to interpretation. In these instances, you have made what appear to be reasonable and defensible assumptions.

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 SSC Board. We have observed that due to your chosen bill profile, your ratios display a declining trend. We also observed that your financial ratios are weaker when modelled on Ofwat's notional structure compared to your actual structure. To help allay any potential concerns your position might generate, we recommended that you sought additional third-party confirmation that stakeholders, and specifically investors, would be comfortable with the financial ratio profiles your plan generates.

A number of Business Plan tables feed and/or are fed by the financial model. We sampled a limited number of these egg relating to natural and modelled PAYG and RCV run off rates. At the time of drafting this report, data was still subject to change. You have confirmed that any changes will be assured through your internal process, to ensure consistency between models tables and consequential narrative.

INTERNAL AUDITOR'S REPORT TO SOUTH STAFFORDSHIRE WATER PLC

Why was the audit conducted?

In accordance with the Company's Assurance Framework, the Group Internal Audit function (provided by South Staffordshire Plc) was requested by the business to review the reported data contained within certain PR19 Business Plan data tables (the PR19 tables) to provide independent assurance.

The PR19 tables consist of 77 detailed schedules containing both financial and non-financial information. The production and accuracy of the PR19 tables is the responsibility of South Staffordshire Water.

Internal Audit was requested to undertake an audit of specified PR19 tables to provide independent reasonable assurance over the information contained therein. Reasonable assurance is considered to be a detailed review, but is not a guarantee that the audit will detect all misstatements or errors.

What were the audit objectives?

The production of the PR19 tables is a complex process involving a significant number of key staff (including senior management and directors) throughout the business, many information sources and various business models. In view of this, it was not expected by the business that Internal Audit would check the accuracy of all information sources and the workings of the business models.

The objective of the audit work undertaken (using substantive, sampling and analytical techniques) was to review selected supporting documentation and obtain relevant explanations to audit enquiries to support the reliability of the information being reported within the tables.

What was included and not included in the audit?

In accordance with the Company's Assurance Framework, the PR19 tables were risk rated by the business. Tables considered high risk have been independently audited by external professionals Jacobs (UK) Limited and Oxera. These high risk tables are outside the scope of Internal Audit. Internal Audit has not undertaken any audit work on these tables and provides no opinion thereon.

The Company has allocated specific PR19 tables rated below high risk for Internal Audit review. Internal Audit has reviewed 44 tables as set out in the appendix to this report.

Audit Findings and Observations

Internal Audit has utilised substantive, sampling and analytical techniques to perform tests relating to the inputs required for each table.

The PR19 tables were provided to Internal Audit in a spreadsheet format containing links and references to the appropriate electronic supporting information and files. Where input information cells were blank or information was found to be hard coded, the PR19 project team were requested to provide the necessary link or supporting information.

A key audit task was to confirm that the PR19 tables were linking to the appropriate sources of information. Two minor errors were identified and subsequently corrected by the PR19 project team. Based upon substantive testing and explanations received, Internal Audit is satisfied that the PR19 tables (where tested), are linking correctly to supporting documentation.

For financial and operational information for 2017/18 and prior years, Internal Audit has performed audit testing to confirm consistency to published documentation which included, but was not limited to Statutory Accounts, Annual Performance Reviews and Cost Assessment tables.

Where possible, Internal Audit has agreed information for the year ending March 2019 to the internal budgets approved by the Board of Directors and the Executive team.

Information for future years comes from a variety of sources. The majority of the financial information comes from the financial model provided by Ofwat. Internal Audit has sought to confirm that the PR19 tables have been correctly linked to this model. In view of the complexity of this model, Internal Audit has not undertaken any audit work to confirm the accuracy of this model.

Future operational information has been provided based upon both historical trends and the stated business strategy. Internal Audit has reviewed this operational information and where the data supplied has shown significant variation to expectations or previously reported numbers, Senior Management has been requested to provide appropriate explanation.

Internal Audit has also considered the financial and operational information provided against the knowledge and understanding of the business and its future strategy obtained during the course of the audit (sense checking).

The PR19 tables provide a number of links where information can be seen or referenced to two or more tables. Links within the tables have been established by Ofwat and these have not been subject to any audit work. However, Internal Audit has identified further areas where similar information (subject to price bases) is contained in two or more tables for example dividends paid appears in App 8, App 11 and App 18. Internal Audit has performed consistency tests where appropriate.

Internal Audit has identified and raised 167 queries and questions with the PR19 project team and has received satisfactory responses to all of these review points. As a result of these responses Internal Audit noted a small number of errors. These errors have been brought to the attention of the PR19 project team and have subsequently been corrected to the satisfaction of Internal Audit and the amendments have been verified prior to the submission of the PR19 tables.

Independence

The business benefits from independent reviews performed by an Internal Audit function operated by the Company's parent South Staffordshire Plc. The function is managed by Glyn Palmer BA (Hons) FCA a qualified Chartered Accountant with over 25 years professional experience within the water industry.

Audit Opinion

Whilst the audit work undertaken was designed to reveal inconsistencies and errors in data tested, the complexity and volume of information contained within the tables means that Internal Audit can only provide reasonable assurance (not guarantee) that the tables are reliable and accurate.

Based upon the audit work undertaken and appropriate evidence obtained, Internal Audit has evaluated the 44 PR19 tables within its testing scope and these are, in the opinion of Internal Audit consistent with supporting documentation received and explanations provided by the management of the business

Glyn Palmer BA (Hons) FCA
Group Internal Audit Manager
30 August 2018

Appendix:

Tables reviewed by Internal Audit.

1	App4 – Customer metrics
2	App7 - Proposed price limits and average bills
3	App8 - Appointee financing
4	App10 - Financial ratios
5	App11 - Income statement based on the actual company structure
6	App11a - Income statement based on a notional company structure
7	App12 - Balance sheet based on the actual company structure
8	App12a - Balance sheet based on a notional company structure
9	App13 - Trade receivables
10	App14 - Trade and other payables
11	App15 - Cashflow based on the actual company structure
12	App15a - Cashflow based on a notional company structure
13	App16 - Tangible fixed assets
14	App17 - Appointee revenue summary
15	App18 - Share capital and dividends
16	App19 - Debt and interest costs
17	App20 - Cost of debt / analysis of debt
18	App22 - Pensions
19	App24 - Input proportions
20	App29 - Wholesale tax
21	App30 - Void properties
22	App 32 - weighted average cost of capital
23	WS1 - Wholesale water operating and capital expenditure by business unit
24	WS1a - Wholesale water operating and capital expenditure by business unit including operating leases.
25	WS3 - Wholesale water properties and population
26	WS4 - Wholesale water other (explanatory variables)
27	WS5 - Other wholesale water expenditure

28	WS7 - Wholesale water local authority rates
29	WS8 - Third party costs by business unit for the wholesale water service
30	WS18 - Explaining the 2019 Final Determination for the water service
31	Wr1 - Wholesale water resources (explanatory variables)
32	Wr2 - Wholesale water resources opex
33	Wr3 - Wholesale revenue projections for the water resources price control
34	Wr4 - Cost recovery for water resources
35	Wr5 - Weighted average cost of capital for the water resources control
36	Wn1 - Wholesale water treatment (explanatory variables)
37	Wn2 - Wholesale water distribution (explanatory variables)
38	Wn3 - Wholesale revenue projections for the water network plus price control
39	Wn4 - Cost recovery for water network plus
40	Wn5 - Weighted average cost of capital for the water network plus control
41	R1 - Residential retail
42	R3 - Residential retail ~ further information on bad debt and customer services
43	R7 - Revenue and cost recovery for retail
44	R8 - Net retail margins