

C9 Financial modelling data set

Changes from Draft Plan

- Resolution of Reservoir issues at Draft Business Plan results in less comments required
- Capital outperformance bonus required manual adjustment in K solving routine

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Introduction and Summary

We have prepared the business plan tables using the Reservoir tariff basket model and financial model.

Our own preparations for PR09 use our own financial model, which correlates very well with the modelling methodology in Reservoir and also acts as our control for capital maintenance, operating costs, revenues and the financial inputs into the Final Business Plan. This process has allowed us to identify issues and be confident in the modelling results we produce.

Where necessary we have adjusted plan inputs in section 9.1, to allow accurate K factor calculation and reporting within Reservoir. Any adjustments made our presentational rather than significant to the K calculated.

1 Draft Business Plan table price bases

This section includes corrected price base tables where the Reservoir has passed a mixture of pricing back to the Draft Business Plan tables.

1.1 B7.1 Financial projections

The table in Reservoir is at average 2007/08 prices. For RCV and net debt, it is more useful to report these at year end 2007/08 prices for the calculation of Debt/RCV gearing. The K4 numbers shown below are the actuals consistent with FD04 rather than with the log up and other K4 adjustments shown in table B7.1.

Excised									

1.2 B8 Turnover

The operation of the WACI adjustment in the tariff basket model affects the turnover reported on table B8. This results in slightly less turnover being reported on this table than on line 2 of table B7. This is a known issue that Ofwat have recognised and is due for consideration in the draft determination version of Reservoir.

Excised									

2 Commentary on Table C9.1

We outline below line by line any supporting commentary required for this table of the business plan, which provides additional inputs into the Reservoir model.

Lines 1 ,2,4,5

Set to 1 to apply base opex efficiencies.

Lines 22 – 31

Standard lives as input on table B7.3 and B7.5. This is not consistent with the June return for 2007/08 because Reservoir will not allow inputs for future years. We have therefore included our future forecast in the base year.

Line 32

Input calculated through our financial model, Water CCD in each year as a proportion of Total CCD.

Line 34 - 36

Rate of return for annuity calculation assumed to be equal to the rate of return of 5.42%. Line 36 is set to zero as we do not believe that a broad equivalence adjustment should be applied.

Lines 41 and 42

The adjustment inserted for water and sewerage CCA revaluation of fixed asset renewals reflects the difference between JR08 current cost fixed assets and the revalued Net Book Value shown in table B7.13 and B7.14 based on the PR09 valuation. This is included in 2008/09 so it impacts the 2009/10 opening CCA fixed assets. The valuation difference of [Excised] water and [Excised] sewerage is inflated by 3.1% to 2008/09 outturn prices from 2007/08 base.

Line 43

Investment – other is input for future years at the 2007-08 value.

Line 44

Stocks assumed to be equal to JR08 value, as per our own financial model

Line 45

Our modelling includes short term deposits (effectively the balance of borrowing committed in advance of expenditure) from our own financial model. Including this results in the correct interest

Line 47

Short term deposits – interest received includes the interest received from our own modelling of short term deposits as described for Line 45 above.

Lines 50 and 55

The entries for Measured income accrual and other provisions have been used to reflect the balance of working capital in order to reflect the net debt within our own financial model. The balance reflects minor differences in timing and calculation taken in populating the debt and working capital entries on C9.

Line 51

The forecast for non trade debtors is included in this line, with the level broadly equivalent to the 2007/08 balance in lines 49 and 51.

Line 52

Accruals and other creditors have been calculated from our financial model, representing other creditors more than and less than one year. Movements on pension prepayments cause most of the increase to this line over that included in lines 52-54 and carried forward from Table 19 Line 25 JR08 in the Reservoir Financial Mode.

Line 57

This line reflects an additional drawdown on an existing lease during 2008/09

Line 59

This line reflects a new EIB loan drawdown during 2008/09.

Line 61

This line reflects the repayment of existing leases.

Line 63

This line reflects the repayment of existing floating rate loans

Line 65

The balance in 2007/08 reflects £100m of fixed rate loans and £212m of index linked loans. The £100m of fixed rate loan expires in 2010/11 and is included in this line up to this point.

Line 66

An index linked loan of £212m (including £12m of RPI linked accretion as at the end of 2007/08) is included in this line at its 2007/08 value.

Line 73

This line includes the accretion of RPI into the value of the index linked loan, using the average RPI included for each year of the plan (2% after 2008/09).

Line 74,76,77

These lines include the opening debt balances. The total reconciliation to net debt is:

Line 45 Short term deposits	£262.447m
Line 65 Loans at fixed rate	£(311.742)m
Line 74 Floating rate debt	£(240.196)m
Line 76 Creditors leasing	£ (73.667)m
Line 77 Long term finance leases held	£(1091.383)m
	<hr/>
	£1454.541m

Line 78

The fixed interest rate for the £100m of fixed rate loan in line 65 is included here.

Line 79

The interest rate on the original £212m of index linked loan in line 66 is included in here [Excised]. The interest rate is input as increasing with the amount of accretion included in line 73.

Line 86

Interest cost on the leases is input into this line. This line also includes the effect of interest rate swaps up until 2011 (by which time they expire). These mainly include swaps on lease interest but also on other financial instruments.

Line 88

Interest costs on floating rate debt is included in this line. Adjustments to interest costs in Reservoir to take into account the impact of interest on current asset deposits and working capital adjustments in line 52 are also included in this line.

Line 89, line 90 and line 91

The closing number of ordinary shares are input with an average share price of £1 to get the total share capital as per JR08.

Line 97

Dividend yield reflects the cost of equity we assume of 7.7% (section B7) less an assumption of 2% real dividend growth included in line 54

Lines 98 and 101

Dividends are paid 100% in the year calculated.

Line 99

The dividend growth rate reflects our forecast for K4 ordinary and outperformance dividends, together with a dividend consistent with a dividend yield of 5.7% with 2% per annum real growth thereafter. The dividend growth rate in 2010-11 adjusts the 2009-10 dividend to the calculated amount set out in section B7.

Line 105 and line 106

Base interest rates reflect our assumption of the risk free rate in section B7, adjusted by 0.8% after 2010 to reflect the differences between the RPI used in assessing the cost of capital (2.8%) with the smoothed RPI we have used in our plan for the purposes of K calculation (2.0% - see section B7).

Excluding the RPI adjustment of 0.8%, these lines sum to the 3.9% real cost of debt we assume in our plan (excluding our adjustment for the impact of existing embedded debt as this line is used to calculate future borrowings).

Line 107

This reflects our own financial model assumption for interest received.

Lines 108 to 112

We assume the same cost of capital for new and existing assets. K4 values reflect the PR04 Final Determination. K5 values reflect our view of the rate of return and the cost of capital set out in section B7. The discount rate is assumed to be the rate of return.

Lines 121, 123 and 124

Forecast income from property sales is shown for the remainder of K4

Line 125 and Line 126

Corporation tax is input as 30% in 2007/08 and reduces to 28% for 2008/09 and beyond, consistent with the Finance Act 2008 and the rate used in our calculation of the cost of capital.

Line 127 to 129

The capital allowance rates reflect the impact of the Finance Act 2008. In particular IBA allowances taper out to zero by 2011/12. Line 118 is used for the general plant and machinery pool and line 120 includes allowances for integral features. This is consistent with table B7.12

Lines 130 - 156

As set out in section B7, we assume a smoothed 2.0% RPI for future years, and a relative price effect for COPI and IOPI of 1% for K5 (therefore input as 3.0%). COPI and IOPI for 2007/08 are consistent with the assumptions used elsewhere in the business plan. Current data for COPI and IOPI is not used in the plan as part of the smoothing principle.

Lines 160 – 162

The IRC trigger in 160 is set for 2010/11 to 2019/20. No other setting affects Reservoir.

As we have adjusted our IRC to reflect actual and planned changes in expenditure, we have used a 2010-2025 period for the purposes of calculating IRC in Reservoir. This calculation built up an unacceptable prepayment over time and therefore we overwrote this calculation of IRC in lines 174 and 178.

This was necessary as an error in Reservoir meant that the standard policy date range of 2010-2025 that we may have alternatively input resulted in a very large prepayment (c. [Excised]) emerging during K5. This would not have been financeable.

Lines 174 and 178

Reservoir requires the input of our 2008/09 and 2009/10 calculations of IRC in these lines. As set out in section B7, we have overwritten the Reservoir calculation of IRC to obtain an acceptable calculation of IRC that reflects our normal policy of a 15 year rolling average that sees the prepayment eliminated at forecast outturn prices within that time period.

Lines 193 and 196

These lines reflect the FD04 outperformance adjustment to the RCV, as confirmed by Ofwat in the opening RCV letter.

Lines 199 and 200

These lines reflect the FD04 assumed revenues.

Lines 201 and 202

This is a calculation of average life from the FD04 Aquarius outputs.

Lines 205 and 206

As set out in section B11, our plan calculates that we will achieve a baseline position of 100. On this basis, no income adjustment is included in these lines.

3 K solving process

This section briefly describes the K solving process we carried out within Reservoir. A copy of the final Reservoir scenario export which includes the K solve sheets is included electronically with the plan.

From our return on capital of 5.42%, the following initial K factors were produced:

	2010/11	2011/12	2012/13	2013/14	2014/15	Average K
K	6.9	3.5	3.0	1.7	1.8	3.36

Total K5 revenues amounted to [Excised].

We set the Gearing range in input F110 (manually in the financial model) to be set to a minimum of 60% and maximum of 65%. 60% is consistent with the cost of capital calculation set out in section B7.1. No gearing or interest adjustment was made in running K solving due to the consistency between our actual and the notional gearing. The average interest rate included in our plan is below that implied by the cost of capital due to the impact of existing borrowings. This makes gearing and interest adjustments inappropriate.

No targeting was carried out. At this stage the NPV of revenues was [Excised].

Adjusting the bankable K was based on a manual adjustment due to the Reservoir known issue the details are shown below:

Excised						

The rate of return from this profile averaged 5.45% against the 5.42% implied by our cost of capital assumption. The total NPV of revenue post adjustment was **Excised**.

Reprofiling could have resulted in the following smoothed K factors

	2010/11	2011/12	2012/13	2013/14	2014/15	Average K
K	4.3	4.3	4.3	4.3	4.3	4.3

Because of the impact of RPI deflation on prices, we decided that K smoothing was not in customer interests for our FBP.

4 Reconciliation to our financial modelling

Below we reconcile the key financial information produced by Reservoir against our own financial modelling. These comparisons are carried out at Base 2007/08 prices. This helps to identify any modelling issues that require further exploration for the final business plan. It also provides confidence that the K calculation in Reservoir and risk modelling we carry out using our own modelling are accurate.

4.1 Turnover

Excised

Reservoir produces slightly more turnover than our modelling due to simplifications within the Tariff Basket Model. This is because Reservoir does not start from 2008/09 and 2009/10 actual tariffs in order for this difference to be removed. Tariff rebalancing differences also explain this impact.

4.2 Operating costs

Excised

Small differences to the working capital adjustment and efficiency calculations are not material.



4.3 IRC

Excised

We made the two models consistent due to the difficulties faced in the IRC calculation within Reservoir. Effectively we adjusted Reservoir to the best proxy to the IRC projection we had calculated within our own model.

4.4 CCD

Excised

Reservoir produces slightly higher CCD than our own modelling. It is not clear to us what the cause of this difference is, which emerged with the final Reservoir model. We believe it may be a repricing issue. However, no material impact on K calculation is observed between the models and therefore this may be a matter of presentation.

4.5 Interest

Excised

Due to the nature of the interest calculation in Reservoir, we have replicated our own modelling of interest exactly.

4.6 HC profit before tax

Excised

This difference is almost entirely driven by Turnover.

4.7 Taxation

Excised

Our model includes some differences in tax calculation that appears to result in slightly higher cash tax requirements than Reservoir.

4.8 RCV (2007/08 year end prices)

Excised

Despite the differences in CCD calculation reported on B11, at 2007/08 year end prices the models broadly reconcile.

4.9 Net debt (2007/09 year end prices)

Excised

Adjustments to Reservoir working capital for each year have produced an approximate Net Debt position the same as the SWW model.

4.10 Dividends

Excised

There is a small difference in the calculation of dividends which is due to repricing of RCV.

4.11 Table B7.10 Broad equivalence adjustment

The differences in CCD numbers produce a difference in the NPV calculation. The SWW model suggests that the adjusted difference is equivalent to 1.52% of turnover. Reservoir produces a calculation of 7.18% of turnover. As these both have MNI less than CCD, there is no impact on financial modelling of this difference. The Reservoir calculation is marginally above the threshold, but as this appears to be caused by higher CCD in the Reservoir model despite the same K calculation, we do not believe the broad equivalence adjustment this implies should be applied.