Monitoring financial resilience

Ofwat

November 2016

We updated this report on 14 December 2016 on page 18

Introduction

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Welcome to the first full report produced under Ofwat's financial monitoring framework. The aim of this report is to provide information to interested stakeholders on the relative performance and financial strength of the water and wastewater companies ("the appointed companies") which Ofwat regulates.

We introduced the financial monitoring framework in 2015 to collect, analyse and report on information on the appointed companies which would provide a clear view of their financial performance, solvency, liquidity, risk management and longer-term financial viability and resilience in light of anticipated investment programmes. We also published an initial pilot report in October 2015 which used information that was publicly available at that time.

The purpose of the financial monitoring framework is to:

- enhance visibility and transparency of financial and capital structures in the sector;
- assist Ofwat in monitoring the financial stability of the businesses that we regulate and enable other stakeholders to consider and challenge the sector in its identification and management of risk;
- identify financial, structural and systemic risk which may impact on service delivery over time and prove harmful to customers; and,
- help us in determining when we need to use the regulatory tools available to us to intervene to protect customers' interests.

By analysing and presenting the companies' own data in this way we are seeking to improve the transparency of reporting and the accountability of companies to all their stakeholders. The ability to benchmark each of the appointed companies against their peers, where relevant, will also reinforce the effectiveness of Ofwat and other stakeholders in holding these providers of a vital public service to account.

Background

In line with Ofwat's strategy and our duties with respect to resilience and consumer protection we developed a suite of financial metrics to provide stakeholders with information about the financial health of each of the appointed companies. This data will also enable us to monitor changes in the financial position of each of the appointed companies over time. This information will also be used to inform our proportionate and targeted approach to regulation in future.

These financial metrics have been incorporated into the Annual Performance Report ("APR") which appointed companies are required to publish each year. Along with the income statement, statement of financial position, statement of cash flows and other information that companies are required to disclose, this information will create, over time, a valuable database of comparable information covering the performance and relative financial strength of each of the appointed companies.

By asking those companies to prepare and publish information in this way both Ofwat and other interested stakeholders will be able to compare performance, identify outliers and provide challenge to appointed companies who are underperforming, or who do not appear to be acting in the best interests of customers, while learning from good practice and those appointed companies which are performing well.

The Water Act 2014 added a statutory duty for Ofwat to further the resilience objective, highlighting the need for long-term resilience of water and wastewater systems and service provision for customers when faced with increasing external stresses. We consider resilience to be the ability to cope with, and recover from, disruption, and anticipate trends and variability in order to maintain services for people and protect the natural environment now and in the future. Resilience has always mattered to Ofwat, as it matters to customers, and while this duty has now been formalised our approach has always considered the need for resilience in services, in systems (including the environment) and in ensuring that companies are demonstrating both financial and corporate resilience.

Each company's management and investors are responsible for determining the company's capital and financial structure, and they, not customers, bear the risks associated with it. Allocating risk to those best placed to manage it creates an incentive for it to be managed efficiently, which over time helps to drive down costs for customers. This is an important feature of the water industry and provides an incentive to appointed companies to manage risk efficiently while implementing a structure which works for them.

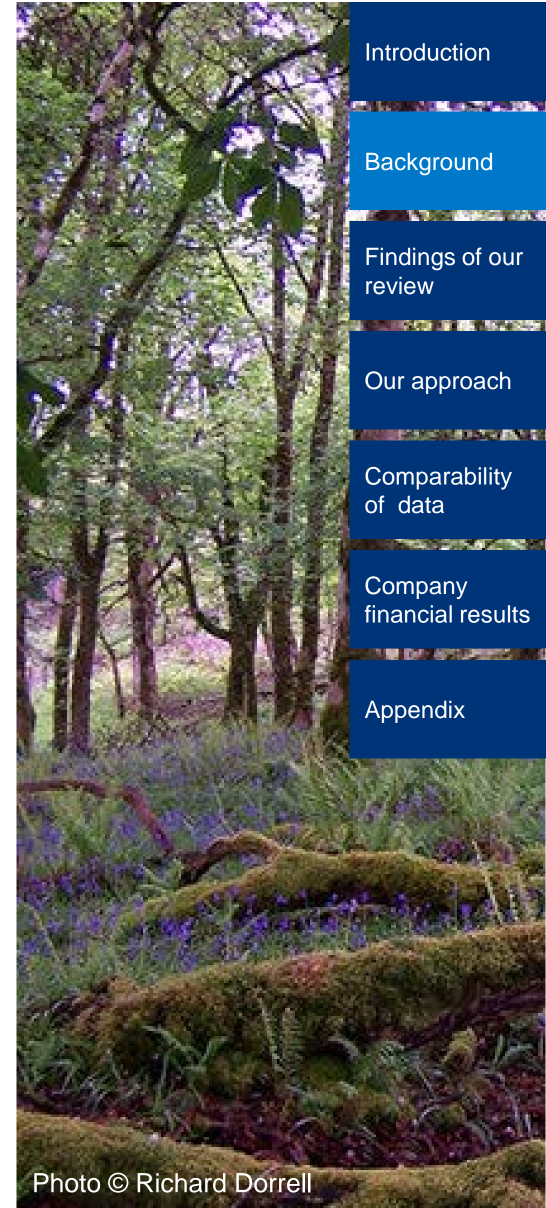

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Photo © Richard Dorrell

Introduction

Background

Findings of our review

Our approach

Comparability of data

Company financial results

Appendix

We have considered the information that appointed companies have published in their Annual Performance Reports for the 2015-16 financial year and their responses to additional questions that we have put to them concerning the data they have published. We have also considered other publicly available information (e.g. reports from the credit rating agencies) and financial information published after the APRs.

It is important that companies maintain their financial and corporate resilience alongside the resilience of their assets and ecosystems. We constantly monitor financial and non-financial information about appointed companies and will intervene where necessary, in a proportionate and targeted way, to protect the interests of customers.

In looking at the information on financial resilience set out later in this report we note that we have not identified any general concerns over the financial resilience of the appointed companies nor have we identified any specific areas where we need to intervene to protect customers at this point in time. In doing so, we will not undermine the responsibility of the appointed companies and their investors for the identification and effective management of risks to financial resilience.

The key findings of our review are as follows:

- All companies required to hold an investment grade credit rating are at least two notches above the minimum level required. We note that a number of companies are on negative watch and remind the management of those companies that it is their responsibility to ensure that they act to maintain an investment grade credit rating.
- As expected the interest rates information reported by companies indicates there is some variation in the rates that are being paid by companies. We note that there is one WoC which has reported interest rates which are significantly higher than we might have anticipated while there are two WaSCs which have reported interest rates which are below the levels we might anticipate.
- There have been a number of changes in regulatory gearing in 2016 compared to 2015. Our review indicates that this is largely as a result of changes made to the RCV by Ofwat as part of the PR14 price review which reflect performance by the companies in 2010-15. There is no evidence that companies have been actively seeking to increase gearing over the last financial year.

- Total pension deficit liabilities at 31 March 2016 are c.60% lower than the levels reported at 31 March 2015. We note however that market interest rates have been volatile since the Brexit referendum vote in June 2016 and inflation expectations have changed and this may well result in marked increases in those liabilities. We have previously set out the level of funding that would be allowed for historic deficits and the dates when that will end. We have set a cap on the level of pension deficit funding that can come from customers and any deficits over and above those levels remain the responsibility of shareholders.
- All companies were required to publish a statement on long term viability for the first time in 2016. Companies were required to produce forward looking forecasts and stress test those forecasts. Company boards have made statements that they have considered forward looking forecasts covering periods between three and eight years and have satisfied themselves that the company is financially viable over the specified period. In making their statement on long-term viability a number of companies, but not all, have considered a period of five years and we would strongly encourage all appointed companies to consider a period of at least that length in the future. We would also encourage companies to ensure the statements that they make are as transparent as possible about the risks they have considered in reaching their conclusion.
- Dividends reported in 2016 reflect both dividends paid in respect of the first year of the current price control period but also amounts declared following the conclusion of the previous period. As a result some companies are paying dividends which are higher than the levels we assumed in the PR14 final determinations. This is only the first year of the price control and we will continue to monitor the level of dividends paid. If companies which have used the levers available to them to resolve short term financeability issues subsequently pay excessive levels of dividends, then we will take this into account at the next price review.

We also note that:

- Companies have published their return on regulatory equity (RORE) for the first time in 2016. Some issues were identified with the original data reported by companies, which was not always reported on a consistent basis. After discussions with all companies we have now obtained assurances from all companies that their calculations are in line with the guidance issued by Ofwat.
- Some errors have been identified relating to the reporting of retail revenues and retail profit margins. We have been in contact with those companies concerned and they are working to improve their reporting in future.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

We published a pilot report ‘Monitoring financial resilience – a snapshot’ in October 2015, which used a limited amount of publicly available information in respect of the financial years ended 31 March 2014 and 31 March 2015. Subsequently we developed a suite of financial metrics with input from the appointed companies and other stakeholders to provide further information on the performance and strength of those companies.

These metrics have been incorporated into the Annual Performance Reports (“APR”) (Table 4H) which has been published by the appointed companies for the first time in 2016. We have used these metrics along with other information published in the APRs to compile this report. We have also used this information and other published sources of financial intelligence, including reports from analysts and the credit rating agencies, to assess the financial resilience of the appointed companies.

This is the first time that this type of data has been collected and analysed in this way. Our approach to how we will use the information published by the appointed companies in this report will continue to develop and be refined over time as both Ofwat and the appointed companies learn from the process and as best practice evolves. We will keep the information requested from the appointed companies under review and may ask companies to provide alternative financial information in the future if it provides a better picture of the financial health of these businesses.

Our approach seeks to ensure that the appointed companies are reporting relevant information about their financial performance in each year, about their financial position and their financial resilience overall.

This report sets out how we have sought to ensure that the data provided by each of the appointed companies has been presented on a comparable basis and also our conclusions about the financial strength of the appointed businesses.

In the section on company financial results we set out a selection of the financial metrics published by each company to enable stakeholders to see the relative position of each company. These include metrics relating to the structure and financing of each business, including gearing, credit ratings, debt composition, interest rates and cash flow metrics. We then look at other performance measures including revenue, profitability, dividends and tax.

To enable us to make meaningful comparisons between companies it is essential that the information about each company is compiled on a consistent basis. Having reviewed this first year of published data we have identified a number of areas where data was not prepared on a consistent basis, in line with the Ofwat guidance, or where the basis on which Ofwat collected information requires improvement. As a result we have been in touch with companies to obtain further information or clarification from them where necessary. Companies are responsible for updating the information on their own websites where errors have been detected.

Where we have identified inconsistencies in the calculation or presentation of pieces of information which companies have been unwilling or unable to amend then we have highlighted this in our commentary.

We recognise that there may be good reasons why companies may wish to present alternative versions of specific metrics which we have asked them to publish. In this case we have asked companies to make it clear that they are using an alternative approach and to clearly state how their alternative calculations differ from the approach specified for the APR.

We will be reviewing and refining the guidance given to companies concerning the APR. Some of the guidance has already been updated and we are aiming to publish any further guidance required before the end of the financial year.

We will also be highlighting examples of good practice in this report.

We do not expect any one company to be identical to all other companies. However, we believe that, where appropriate, a company should be able to explain its relative position and understanding this will both improve awareness and management of risk.

Where appropriate we have included the financial results of Bazelgette Tunnel Limited (Tideway or TTT) which is currently constructing the Thames Tideway Tunnel. While Tideway is a regulated business, its activities are significantly different to those of the other regulated water and wastewater companies and as a result we do not expect its financial performance to be directly comparable with that of the other regulated companies.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Photo © NaJina McEnany

In the next sections we set out information about the financial performance and resilience of each appointed company.

Most of this information has been extracted from the APRs and statutory accounts published by each appointed company.

We have not commented on every piece of information that companies have published, but instead present highlights from the APRs and from the other information that we have reviewed.

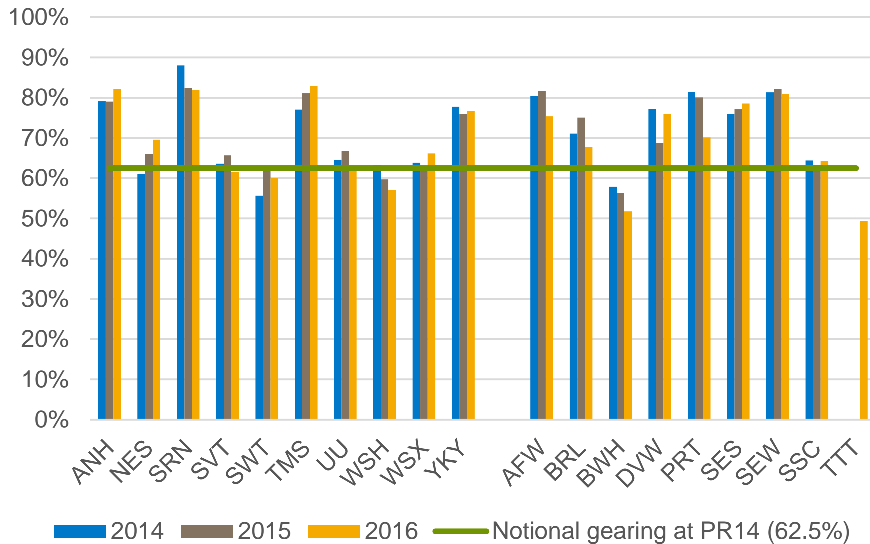
Where we have concerns regarding the comparability of information published then we have highlighted these in the commentary.

We focus initially on metrics which demonstrate companies' financial structure and financing
- gearing
- credit ratings
- composition and maturity of company borrowings
- interest rates
- cash flow metrics, including interest covers, FFO/Debt, RCF/Capex

We then look at relative financial performance
- wholesale and retail revenues
- retail profit margins
- return on regulatory equity (RORE)
- other return measures
- dividends
- corporation tax
- pension liabilities

Finally, we look at the long term viability statements that companies have published for the first time this year.

Gearing



Regulatory gearing is the ratio of net debt for the appointed business to its regulatory capital value (RCV). Net debt excludes any pension deficit liability and mark-to-market accounting adjustments.

Regulatory gearing for the industry (excluding Tideway) ranged from 52% to 83%, in comparison for the 2014-15 financial year when the range was 56% to 82%.

The gearing for Tideway was 49% and this company is reporting for the first time this year. The construction of the Thames Tideway Tunnel is at a relatively early stage and this relatively low gearing reflects both this and the early stage financing of the project.

For AMP6 (2015-20) we have assumed a notional efficient capital structure with a notional gearing level of 62.5%.

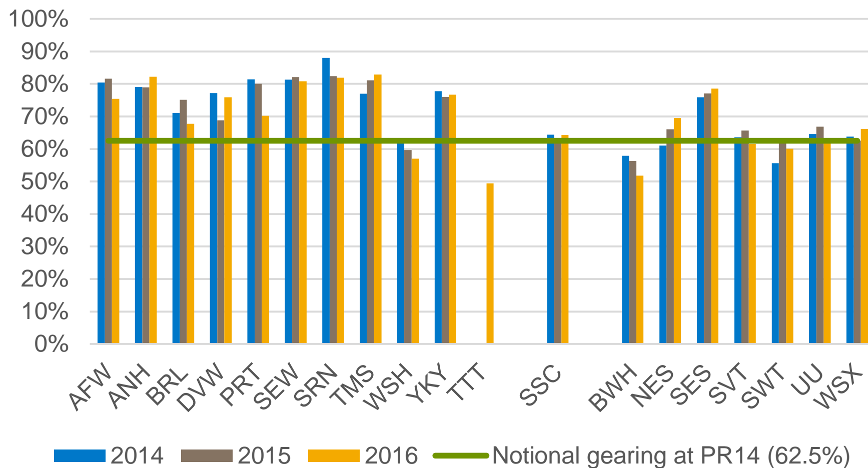
The actual level of gearing that companies choose is a matter for their management and investors, and the risks associated with those choices remain with investors. The use of notional gearing level, which reflects an efficient capital structure, when we set prices, protects customers from the effects of companies' actual choices of gearing.

The chart shows that for a significant number of companies there has been a change in gearing, 8 up and 10 down, between 2015 and 2016. In the majority of cases this change has arisen due to adjustments made to the company's RCV as part of the PR14 price control reflecting performance in 2010-15. There is no evidence that companies have been actively seeking to increase their gearing levels over the last financial year.

A number of companies have also chosen to publish alternative calculations of gearing – in most cases these alternative calculations are linked to specific borrowing covenants linked to particular debt instruments. These alternative calculations are specific to each company and have not been considered here.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Gearing – securitised companies



As set out earlier, the choice of capital structure is a decision for companies and their investors and the risks associated with the choice of capital structure remains with investors and are not passed on to customers. As companies and their investors are able to choose the company's structure we would not expect the gearing level to be the same for all companies.

A number of companies have entered into whole business securitisation arrangements which has enabled them to increase the level of their gearing without incurring a relative increase in their borrowing costs. Under this type of arrangement lenders impose an increased level of restriction over the way in which the company must operate. This reduces flexibility for management and may restrict the ability of the company to pay dividends.

See Appendix for further information about securitisation.

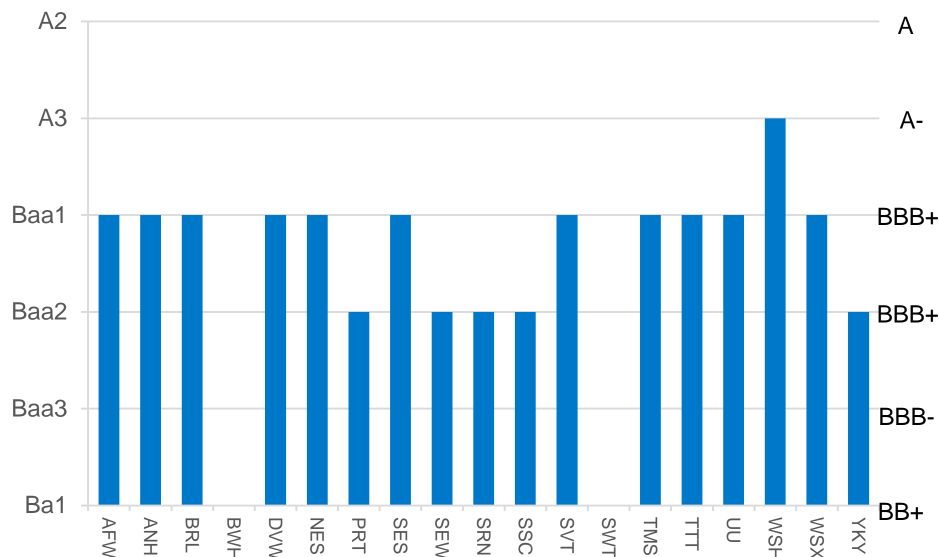
The chart shows the relative gearing levels for securitised companies compared to those which are not securitised.

For securitised companies (excluding Dŵr Cymru) gearing ranged between 68% and 83% (69% to 82% in 2014-15).

Dŵr Cymru (Welsh Water) is owned by Glas Cymru, a single purpose not for profit company with no shareholders, and is run solely for the benefit of its customers. Under Glas Cymru's ownership, Dŵr Cymru's assets and capital investment are financed by bonds and retained financial surpluses.

South Staffordshire Water (SSC) has a hybrid structure, having raised debt which has the characteristics of securitised debt, but the company is not fully securitised.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix



Each company's management and investors are responsible for its capital and financing structure. As a result they are also responsible for determining the level of credit rating headroom that they consider appropriate.

The chart shows that all companies, other than South West Water and Bournemouth which are discussed below, currently have credit ratings which are at least two notches above the level at which they would no longer considered to be investment grade (Ba1).

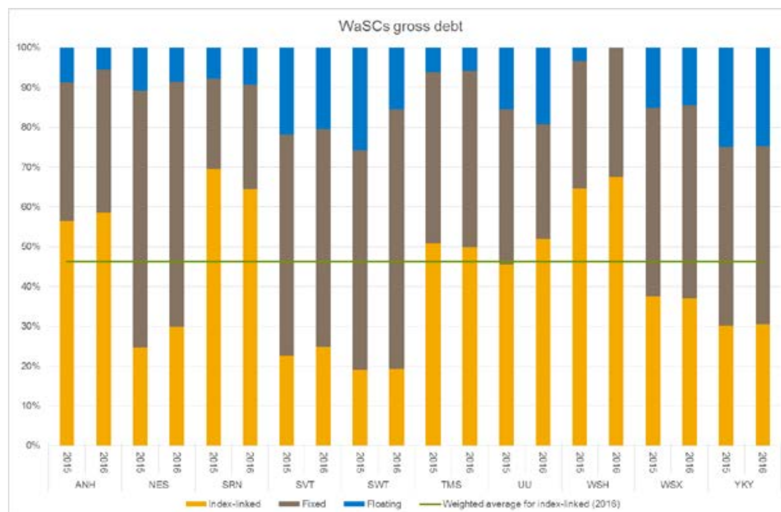
It is a condition of most companies' licences that they are required to maintain an investment grade credit rating from one of the main credit rating agencies. Ofwat have a duty to ensure that an efficient company can finance its functions and an investment grade credit rating is an indicator that companies are able to access the capital markets.

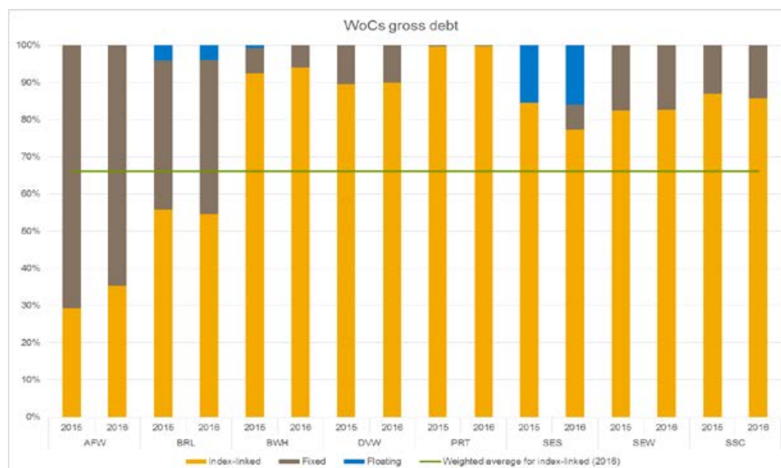
Credit ratings are provided by one of the three main credit rating agencies. The minimum investment grade credit ratings are Baa3 for Moody's Investors Service and BBB- for both Standard & Poor's Rating Service and Fitch Ratings. Where a company has received an issuer or corporate family credit rating from more than one agency, the lowest credit rating received has been recorded. In their sector outlook report published in October 2016 Moody's confirmed that Northumbrian Water, Southern Water and Yorkshire Water are currently on negative watch. We expect company management to take appropriate actions to ensure that their credit rating does not fall below investment grade.

Severn Trent do not have the requirement to maintain a credit rating in their licence which still contains the original terms included in 'Condition F' that were issued to all companies at privatisation – however they do issue bonds and do maintain an investment grade credit rating.

The licence for South West Water (incorporating Bournemouth Water from 1 April 2016) has recently been updated but does not have this requirement because neither South West Water not its parent company Pennon raise finance on the bond market, and as a result they do not have credit ratings. However, its licence does require it to maintain financial metrics appropriate to an investment grade credit rating.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix





The charts provide an analysis of the gross debt of each company. Net debt is used when calculating companies' regulatory gearing.

Net debt is measured by reference to each company's appointed business and includes the value of all cash and borrowings (debt) at the measurement date. Net debt does not include the mark-to-market value of any financial derivatives (or other similar fair value adjustments) and it also excludes the costs of raising debt and accrued interest.

For the purposes of this report net debt also excludes any liabilities in respect of companies' pension schemes which are separately considered later.

Each company is responsible for determining the appropriate composition of its debt portfolio. The data shows that companies are continuing to use a significant proportion of index linked debt to manage their exposure to inflation risk, with WoCs typically using more index linked debt than WaSCs.

For WaSCs approximately 46% of debt was index linked compared to 41% in 2015, while for WoCs it was 66% compared to 67% in 2015.

At PR14 we assumed 33% of companies' net debt was index linked, the use of index linked debt impacts the cash interest payments required each year. This can improve short term financeabiliy but does not impact on companies' overall levels of debt.

Tideway debt is not included above. At 31 March 2016, its debt comprised shareholder loan notes with a fixed coupon.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

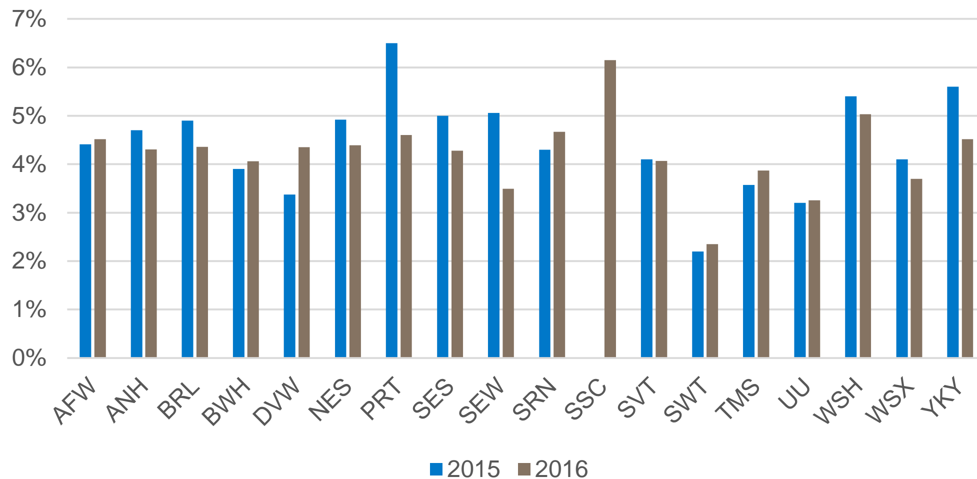
Maturity of company debt

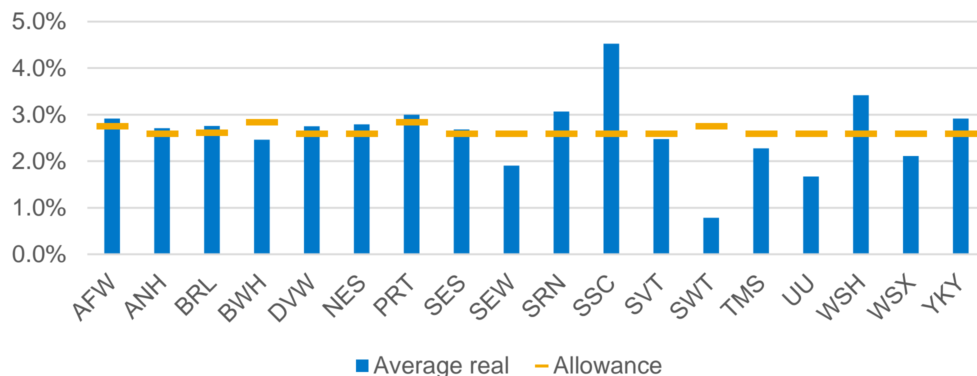
Companies use a portfolio of both long and short term debt to finance their business with each company determining what is considers to be an appropriate mix as shown in the chart.

Companies tend to use long-term debt to finance their operations with the majority of debt being due for repayment in more than five years.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix





The charts in this section show the interest rates paid by companies on their debt, which have been reported by companies in their APR.

The first chart shows the average nominal interest rate paid (including in inflation in respect of index linked debt) which was reported by companies over the last two years. Where no data is included for 2015 this is because companies did not disclose it for that year.

In the next chart we have deflated the average nominal interest rates reported by each company by the March to March inflation rate to calculate a real interest rate and compared that to the real cost of debt allowance that was included in the return given to each company.

The chart shows that while some companies are outperforming the allowance a number are underperforming against the allowance.

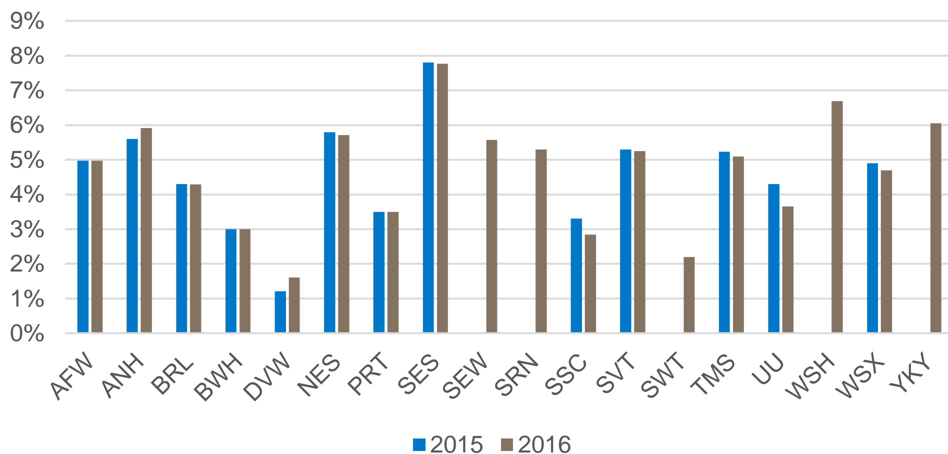
We recognise that the actual level of out or underperformance in respect of the real cost of debt allowance at PR14 will be impacted not only by the interest rate paid but also by the actual inflation rate compared to our assumption at the time when prices were set, and each company's gearing.

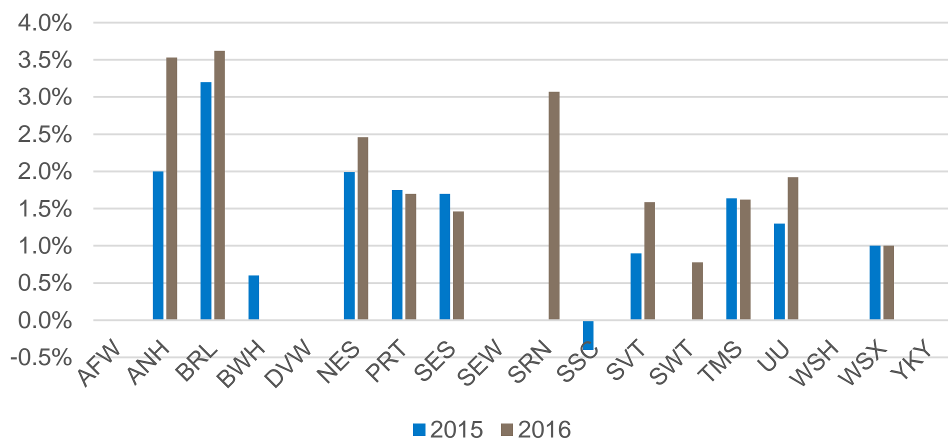
Where companies are able to outperform against our cost of debt, as a result of low real interest rates or due to inflation levels being higher than anticipated, we would expect companies to consider how best to use that outperformance. This could be reducing gearing, reducing pension deficits, improving services for customers or reducing bills.

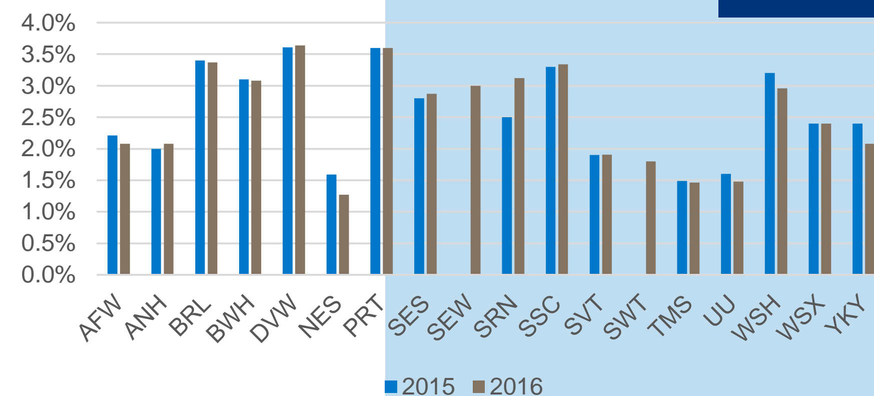
Reported interest rates

For the 2016 financial year, companies also published details of the interest rates paid in respect of their fixed, floating and index-linked debt. These three charts present the nominal interest rates paid in respect of fixed and floating rate debt and the real interest coupon paid in respect of index linked debt.

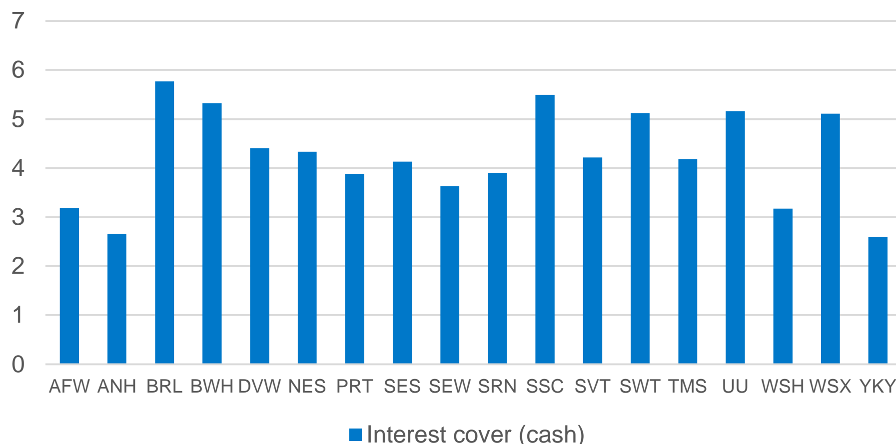
Where comparative information was available for 2015 this has been included in each chart, however this data was not published by all companies for that year.

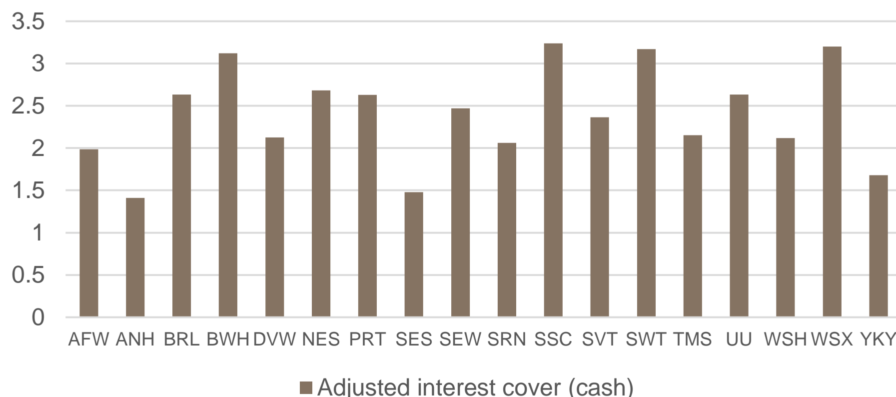






Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix





Interest cover ratios illustrate a company's ability to pay interest on its outstanding debt.

Companies have provided two interest cover ratios in their APR.

The first is a simple cash interest cover ratio which looks at the ratio of Funds from Operations (FFO) before the payment of interest to cash interest payable.

The second chart shows adjusted cash interest cover. In this case the numerator is adjusted to subtract regulatory depreciation which is an approximation of the capital cost that would be incurred if companies were to maintain the RCV at the same level.

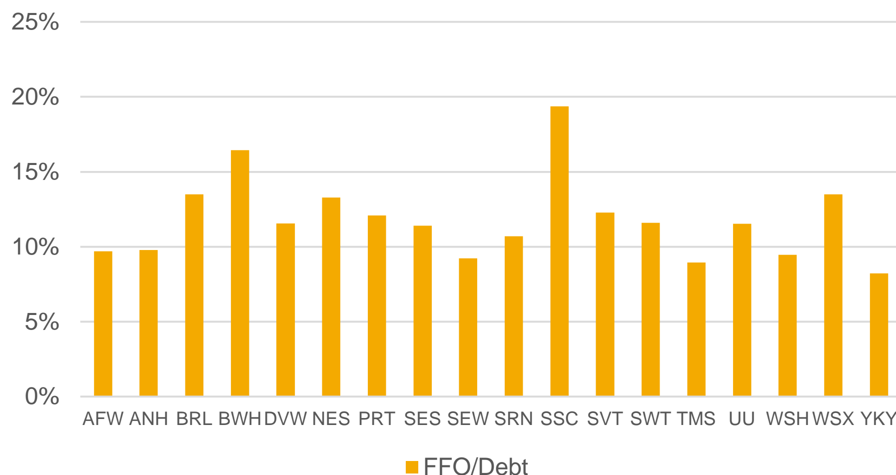
The interest covers for the regulated water companies do not indicate that companies are struggling to meet their interest repayments. For an investment grade company interest covers are usually expected to be above 1.8 and adjusted interested covers are expected to be above 1.2. However these measures are only one part of a suite of information which the rating agencies consider. Each credit rating agency has their own calculation of these ratios which may differ slightly from the calculations here.

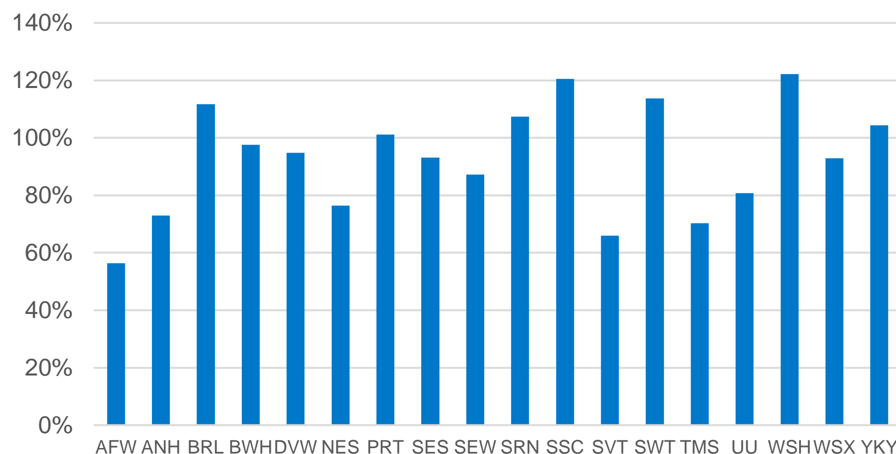
No comparative figures have been included for either ratio as this information was not collected on a consistent basis in previous years.

Anglian Water have adjusted their calculations to remove the impact of interest received from connected companies and as a result their interest covers are slightly lower than other companies.

We have not included any data for Tideway in these charts. The Thames Tideway Tunnel project is still at a very early stage of construction and these metrics are not considered relevant during the early part of the construction phase of the project

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix





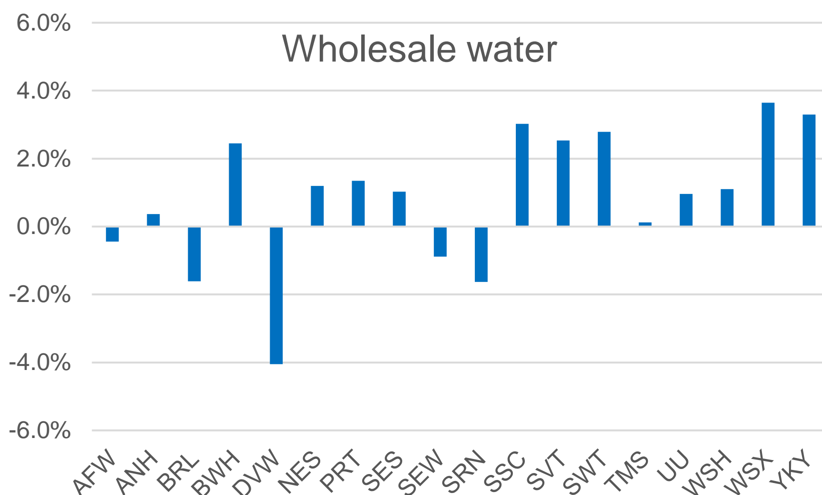
The Funds from Operations (FFO)/Debt and Retained Cash Flow (RCF)/Capex are often used by credit rating agencies to look at the ability of companies to repay their debt and to fund their capital expenditure requirements. Each credit rating agency has their own calculation of these ratios which may differ slightly from the calculations here.

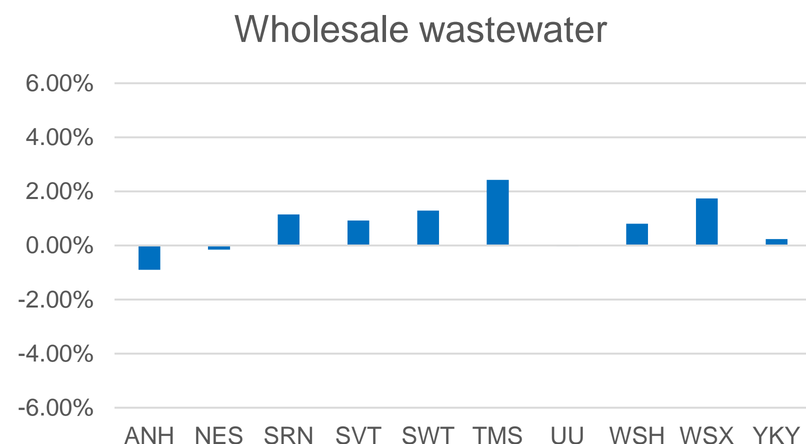
FFO/Debt is calculated as FFO after the payment of interest as a proportion of net debt (excluding any pension liabilities). It demonstrates each company's ability to repay its long-term debt.

RCF/Capex is the ratio of retained cash flow after the payment of dividends but before capital expenditure and demonstrates a company's ability to meet its capital expenditure requirements.

The difference in the metrics seen across the industry is a result of the different capital structures, the differing profiles of the capital programmes that are in place and the way in which they are being delivered.

As noted in the section on interest cover ratios above we have not included these measures for Tideway as they are not relevant metrics for that company. The figures for Anglian Water are lower than for some of the other companies as in making their calculations Anglian Water have adjusted their FFO to remove the impact of intra-group interest received.





We updated these charts on 14 December 2016

These charts show the wholesale water revenue and wastewater revenue, compared to the amounts allowed at the PR14 final determination.

The final determination figures for both wholesale water and wastewater were published in 2012/13 prices. Therefore we have inflated these figures using the November to November RPI, in line with the terms of the current licences, to provide figures which can be compared to the figures published by the companies in their APR.

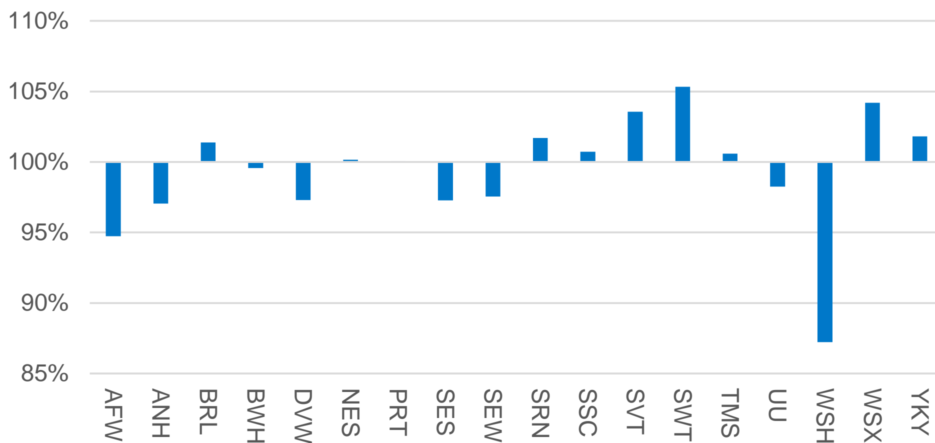
We would expect companies' reported figures to be within a small percentage of the figures estimated at the PR14 final determination. This is the first year of the price control period and small over or under recoveries in respect of each year should be corrected in the following year.

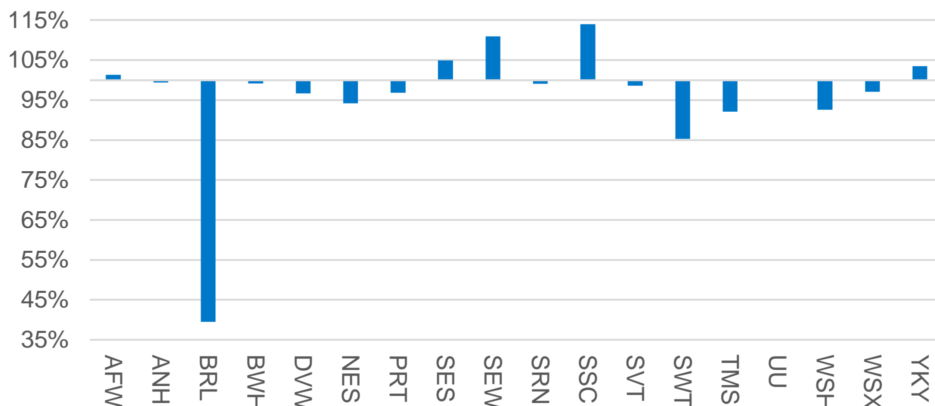
We set separate independent revenue controls for both water and wastewater and any over/under recovery in one control cannot be offset against the other control.

Over recovery of revenue in any year reduces the amount that can be recovered in subsequent years, while the risk of under recovery remains with companies.

Dee Valley Water shows the greatest under recovery of wholesale water revenue in the year. The company notes in their accounts that this was due to a reduction in demand from large non-household customers and the actual number of customers being lower than their original forecast.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix





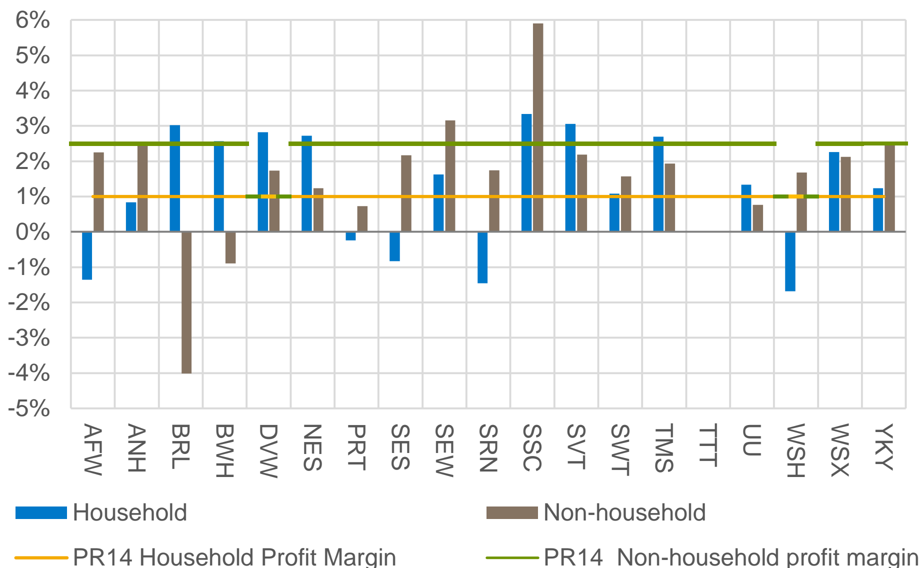
These charts show the household retail component of revenue and non-household retail component of revenue compared to the amounts allowed at the PR14 final determination.

The household and non household controls are separate and costs must be allocated correctly to the relevant control.

The apparent under recovery of household revenue by Dŵr Cymru is due to the number of customers on their Water Assist tariff which reduced average bills for those customers by £212. Dŵr Cymru also had lower non-household revenue as a result of them having fewer non-household customers and choosing to take a lower margin on their contestable water customers.

Bristol Water have noted a misallocation of non-household revenue in their APR submission for 2016, however they believe that they have reported the correct revenue overall. They are now working to address this issue for subsequent years.

We are not including a detailed analysis of companies' expenditure here. We plan to publish more information about company performance in respect of totex and outcomes later in the year.



As part of the PR14 price review we introduced separate price controls for household and non-household retail services and for the first time this year we asked companies to publish their retail profit margins.

In our final determinations companies were allowed a 1% margin for household retail and a 2.5% for non-household retail (except in Wales where companies are operating under a slightly different legislative regime and a 1% margin was allowed). Margins were calculated by reference to the allowed costs at FD.

Companies' actual margins earned can vary from the amounts allowed in the final determination if their retail costs differ from the average cost to serve that we assumed in each companies' final determination.

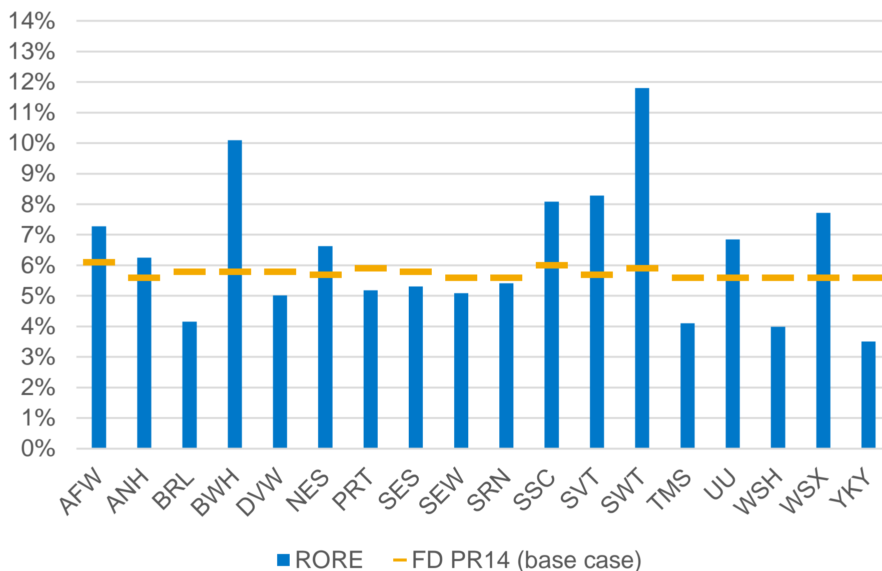
Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix

Where companies' actual retail costs were higher or lower than the costs allowed at the FD then this will have had an impact on the margins achieved. If companies have incurred retail costs in excess of the amounts allowed then there will have been a negative impact on their actual margins. For example, a number of companies highlighted additional costs in connection with preparing for the opening of the non-household retail market in April 2017 which has had a negative impact on their non-household retail margins.

In the same way if companies were able to reduce their retail costs below the amount allowed by making cost savings (including improving bad debt recovery) then this would have had a positive impact on margins seen. For example South Staffordshire Water noted significant retail cost savings in the year which has boosted their retail profit margins in the period. The household and non household controls are separate binding controls and costs (and revenues) must be allocated to the control to which they relate.

Further information about each company's performance can be found in their APRs which each company publishes on its website.

Introduction
Background
Findings of our review
Our approach
Comparability of data
Company financial results
Appendix



Return on regulatory equity (RORE) measures the returns (after tax and interest) that companies have earned by reference to the notional regulated equity, where regulatory equity is calculated from the RCV and notional net debt (62.5% of RCV).

The chart shows the RORE figures calculated by each company and the base case RORE calculated at the FD. In some cases these figures have been updated since the original APRs were published to correct inconsistencies in the calculations.

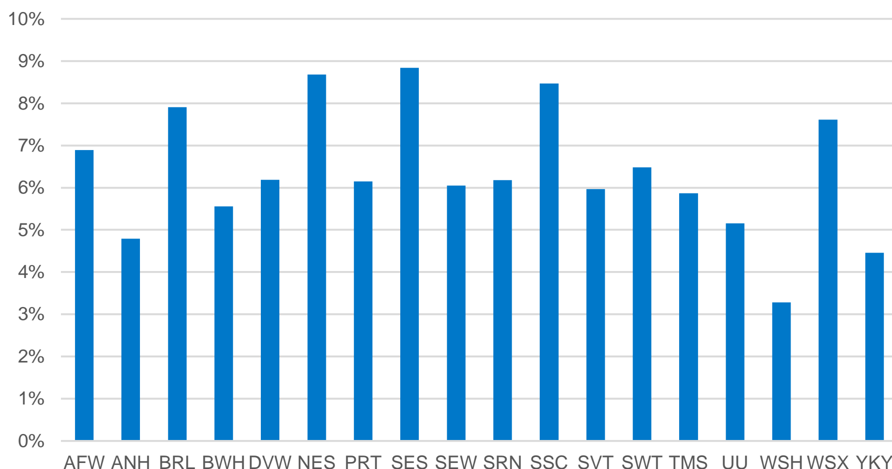
There are a number of reasons why a company's RORE may vary from the base case calculated at the PR14 final determination, which include out or underperformance on allowed expenditure and on financing costs.

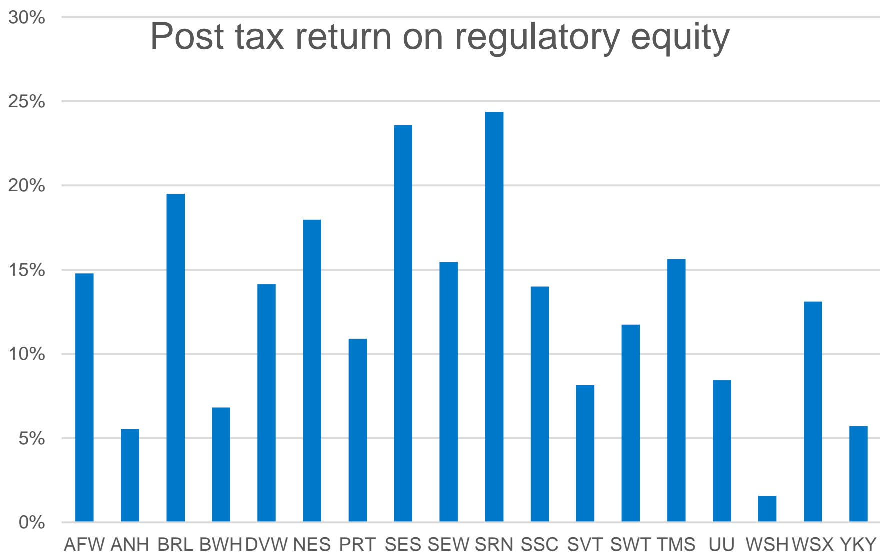
The calculation of RORE by Severn Trent includes a minor error in that it does not fully reflect the notional capital structure. The impact of this error is not material and therefore the figures published by Severn Trent have not been restated above, however Severn Trent will ensure that the correct calculation is used in future years. South West Water and Bournemouth Water have reported the strongest returns as a result of their outperformance in respect of both totex and financing.

For 2016 we did not ask companies to provide a full analysis of the reasons that their RORE varies from the base case. While some companies included this information in their APR, not all companies did. We have therefore updated our guidance so that companies will be required to include this information for 2017 and subsequent years.

We are also aware that companies may wish to use alternative calculations of RORE for different purposes, but we have stressed to all companies the need to make clear any changes to the basis of the calculation so that it is clear that the basis of the alternative calculation differs from that being used by Ofwat.

Return on RCV/Post tax return on regulatory equity





Two metrics which demonstrate companies' actual performance are Return on RCV and Post Tax Return on Regulatory Equity which are shown here.

In the return on RCV shown in this chart the return is measured as the profit for the year after tax but before the payment of interest.

This calculation differs to the base return on RCV set at PR14, calculated using the regulatory building blocks, which was 3.7% for Affinity and South West, 3.76% for Bournemouth and Portsmouth and 3.65% for all other companies.

Variances from these returns are due to out or under performance in the year, differences in the timing of when expenditure is accounted for in the profit and loss account and will also reflect other adjustments made to true up certain over or under recoveries in respect of the previous AMP.

The return used in the post tax return on regulated equity is calculated as profit after tax and interest paid.

Those companies which have a higher gearing tend to have a higher post tax return on regulatory equity due to having a smaller proportion of regulatory equity.

As noted previously Anglian Water have adjusted their figures to remove the impact of intra-group interest received and this has resulted in lower returns.

Introduction

Background

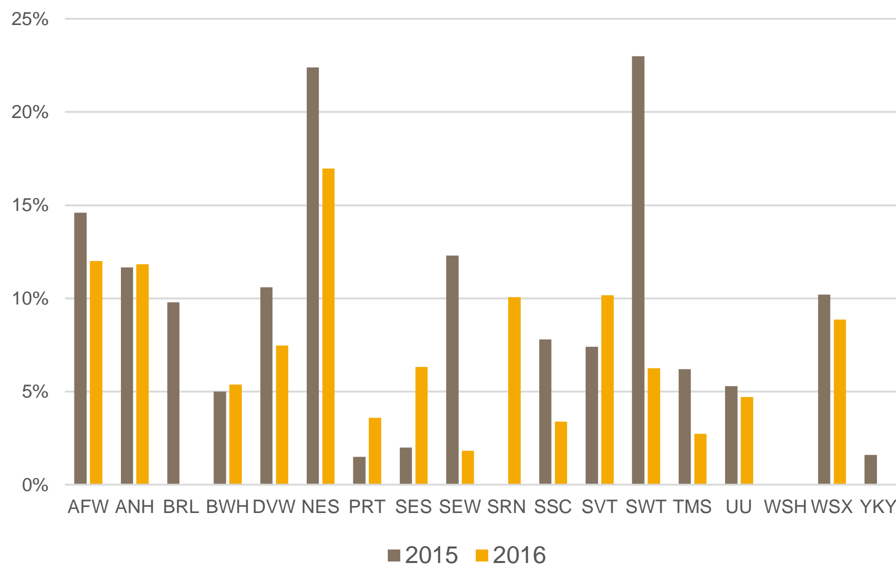
Findings of our review

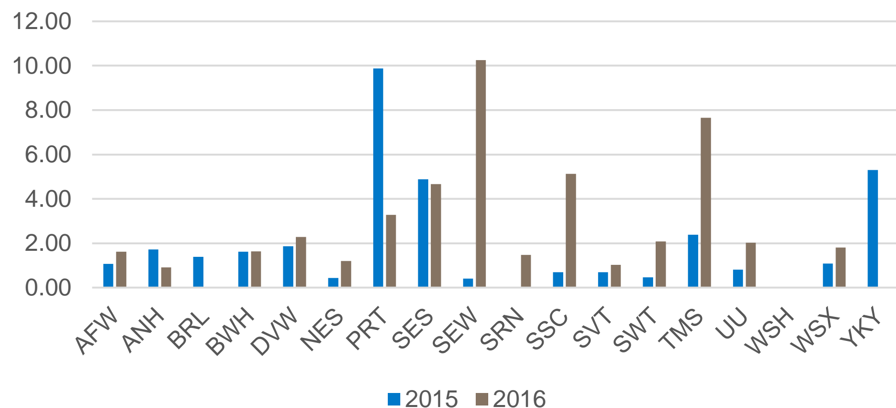
Our approach

Comparability of data

Company financial results

Appendix





Firstly we present the calculation of the dividend yield for the year. Dividend yield is calculated as dividend paid as a percentage of regulatory equity.

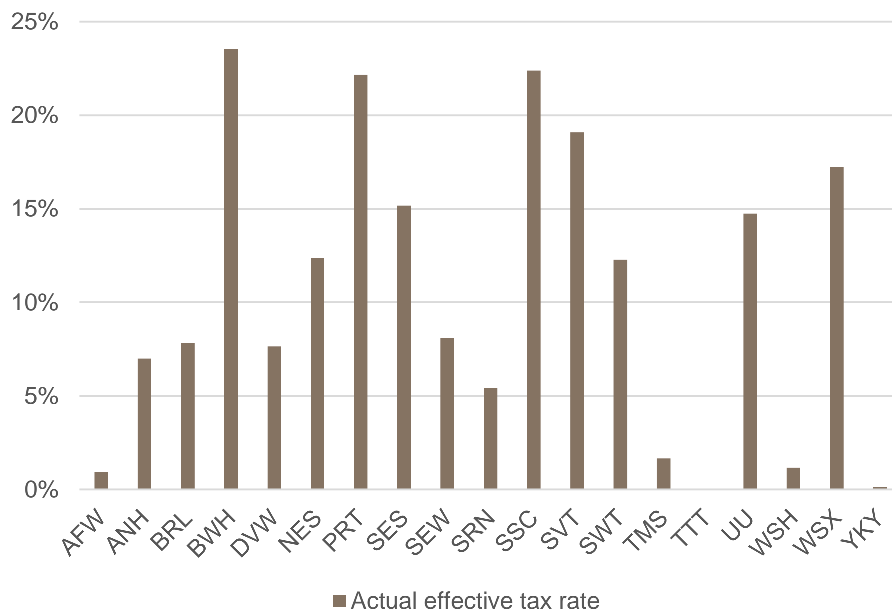
The dividend yield is based on the adjusted dividend paid by each company. This is the total dividend declared in the year less any dividends paid to holding companies to enable those companies to pay interest on intra-group loans from the regulated company and therefore captures only that part of the dividend that is paid out to external shareholders.

For PR14 we assumed a real dividend yield of 4%, but some companies are paying dividends in this year which relate to performance in the previous AMP.

The second chart shows the dividend cover which is the number of times the dividend can be paid from the distributable profits earned in each year.

It should be noted that dividends are not formally recorded in companies' accounts until they have been approved. Therefore while this is the first year of the most recent AMP, in some cases the dividend declared in this year reflects company performance in the previous AMP.

The level of dividend paid will impact on each companies' gearing. Dividends paid in excess of the distributable profits earned in each year will result in an increase in gearing, while reducing the level of dividends paid will reduce gearing. Where companies have used PAYG/RCV run off levers to solve short term financeability issues and then pay excessive dividends then we will take this into account at future price reviews.



The chart shows the effective tax rate that companies paid in the year, calculated as current tax as a percentage of profit before tax and fair value adjustments.

The effective tax rates shown here are slightly different to those included in table 4H of the APR. The reason for the change is that having reviewed this data we identified that the original calculation was incorrectly including prior period adjustments within current tax. We have therefore corrected this calculation and will update the APR guidance for 2016-17.

As can be seen from the chart companies paid a range of effective tax rates which varied between 0.2% and 23.5% compared to the basic rate of corporation tax of 20%.

The actual rate of tax that companies will pay will be influenced by many factors including the level of capital expenditure over recent years as a result of which they can claim capital allowances which defer taxation to future periods.

The disclosures made by companies have also identified that Anglian Water, Northumbrian Water, Southern Water, Thames Water, Wessex Water and Yorkshire Water acquired group relief or consortium relief from connected companies which they did not pay for in full and which has enabled them to reduce the amount of tax paid and hence the effective tax reported is lower than the expected tax rate.

Tax policy is a matter for the UK government and collection of tax the responsibility of HMRC. The effective tax rate a company pays reflects the impact of tax reliefs generally available to UK companies in respect of, for example, capital allowances and pension scheme contributions, along with the availability of group relief transfers or other timing differences.

Introduction

Background

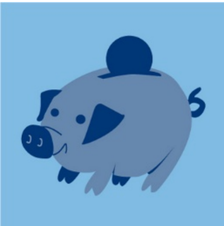
Findings of our review

Our approach

Comparability of data

Company financial results

Appendix



For 2016 we have reviewed reported exposures arising from companies' defined benefit pension schemes.

The net accounting based pension deficit at March 2016 is £440 million, some 60% lower than in 2015 which appears generally to be due to increased discount rates. Changes in the company-by-company exposures are however varied.

All WoCs plus three WaSCs report pension scheme surpluses. The remaining WaSCs have each reported a deficit with the largest deficit, as a percentage of RCV, being 5.1%.

Each company determines the key assumptions utilised, including discount rate and inflation rate, so comparability across companies is difficult to assess.

Most companies have also published sensitivities which are useful in observing potential liability volatility. For example, a 50-basis point fall in the discount rate could equate to an increase in overall liabilities of circa £1bn.

Market rates, in part due to the reaction of the Bank of England to the Brexit referendum vote, and inflation expectations have changed since March 2016 and liabilities may have increased markedly.

While we have no immediate concerns relating to defined benefit scheme deficits, exposures will be kept under review.

Cash contributions to repair pension deficits reflect triennial actuarial valuations undertaken by independent scheme trustees. Valuations may vary from the accounting based valuations as trustees are expected to be prudent in setting their assumptions. For most companies the triennial review date was 31 March 2016 and the scheme valuations are currently underway. The impact on future cash contributions will depend on negotiations between individual companies and their scheme trustees.

The appointed companies are long term business with predictable long term regulation. We would expect that the approach to pension deficits would reflect this long term nature.

Regulatory context

At the PR14 price review we set out our treatment of pension deficit repair costs for the 2015-20 price control period and beyond.

We stated for each company the date at which customer contributions to deficit repairs will end; that we intended to make no further allowances for deficit repair costs after the stated date, and that we did not intend to allow companies to recover from customers any incremental deficit repair costs beyond those assumed at PR14 (which were based on PR09 valuations).

We continue to expect pension deficit repair costs, whether incremental or due after the dates specified, to be dealt with by management action or contributed by companies and their shareholders.

Long-term viability statement

A new requirement for companies this year was to include a long-term viability statement in their accounts.

This requirement follows changes to the UK Corporate Code which now requires all premium listed companies to include this statement in their accounts. Companies are required to make a statement setting out how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate.

In producing this statement we asked company Boards to prepare and stress test a forward-looking business plan in a robust manner and to consider the financial viability of the company over an appropriate forward looking period. Companies were responsible for determining the period over which they made their assessment and we made it clear in doing so that the end of the current price control period should not be a constraint.

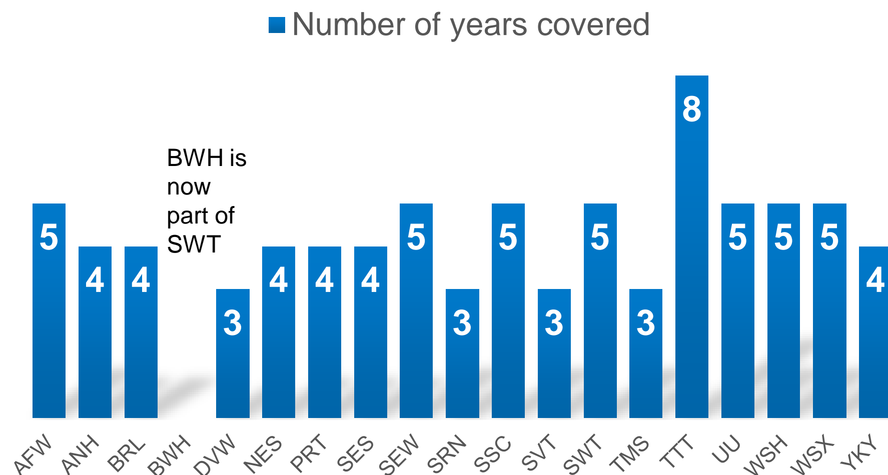
All companies complied with this new requirement this year, however we noted that one company included their statement in their statutory accounts only and did not have an appropriate reference to it in their APR.

The statements made by the companies on the whole set out the risks that they had considered and the approach they used in assessing long-term viability.

We have identified that while all companies complied with the basic requirements to produce a long-term viability statement there was some variation in the quality of information provided about the approach used.

We encourage all companies to ensure that the statements that they make in connection with their assessment of their long term viability include sufficient detail so that the reader can understand the risks that they have considered, the basis on which they have stress tested their business plans and the way in which they have reached their conclusions.

Additionally, and in order to prevent the content of the statements becoming standardised over time, we would encourage companies to engage with and seek feedback from interested stakeholders as to the usefulness of these statements and how they may be improved.



As shown in the chart companies typically selected a forward looking period of between three and five years for their review and in doing so some companies have considered their viability beyond the end of the current price control and not seen it as a constraint. Tideway looked forward over an eight-year period reflecting the nature of the construction phase of the project they are undertaking.

We note that Wessex Water included a forward looking review period of five years in their APR but used a shorter period of three years for the long term viability statement in their statutory accounts.

We set out in IN 16/03 that we would be considering whether we need to implement more prescriptive guidance following the completion of the first long term viability statements.

Based on the statements we have reviewed for this financial year, we do not intend to put more prescriptive guidance in place or to significantly increase the requirements on companies at this time.

However, we note that a number of companies considered a period of five years in their statement and in view of the long term nature of the industry and the relative predictability of revenue, we would strongly encourage all companies to consider looking at a period of at least five years in the future.

A number of privately owned companies have established 'securitised' debt structures and often have a higher gearing than non-securitised companies.

Similar to a household mortgage, securitisation enables a company to raise debt by granting a mortgage (charge) over an identifiable stream of future cashflows generated by the business, rather than through a mortgage on the asset.

In order to protect the quality of future cashflows, a securitised borrower agrees or 'covenants' with its lenders, under a common set of terms and conditions, to maintain the assets to a certain standard and not to sell the assets without consent.

In addition, the company normally agrees, after paying its operating expenses, to use cash generated by the business to pay interest and debt repayment obligations when due, before making any distributions to shareholders.

The way that water companies are regulated means that cashflow is relatively stable and predictable and this type of financing structure has been attractive to investors.

The existence of the common terms and security package means that a company with a securitised structure can support a higher level of gearing with limited impact on interest costs than a non-securitised company while maintaining a similar investment grade credit rating.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

Printed on 75% minimum de-inked post-consumer waste paper.
October 2016

ISBN 978-1-910739-68-23

© Crown copyright 2016

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.