Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans

Introduction

Water companies deliver vital services that are essential for public health, the environment and economy and a well-functioning society. Providing this service is a privilege; customers rightly expect companies to take responsibility for the service provided and be accountable for their actions. This includes how they balance the interests of customers with those of investors. The regulatory framework seeks to best align the interests of investors with the interests of consumers. Some company behaviour has been highlighted which suggests that some companies are not achieving an appropriate balance – such as where companies focus on shareholder returns without demonstrating corresponding benefits to customers.

On 13 April we wrote to the Chief Executive Officers of the water and wastewater, and water only, companies in England and Wales to set out a programme of work to rebuild trust and confidence in the water sector. We recognise that some companies have recognised the need to put the sector back in balance and have started to take steps to redress that balance.

As set out in our letter, we have looked again at the incentives we place on companies in our price controls to assess whether companies are encouraged to strike the right balance between the interests of customers and investors when deciding on how to finance their business. We have considered what we could do to encourage companies to take the interests of customers into account when determining financial structure, particularly where gearing levels are materially above assumptions that underpin price determinations. We have also considered how we can incentivise companies to transparently demonstrate how their policies relating to dividends and performance-related executive pay take account of delivery for customers.

In April, we consulted on some targeted amendments and clarifications to our methodology for PR19 to better align interests of investors in water companies with customers. We set out:

- proposals for companies to share financing outperformance from high gearing;

- expectations for PR19 business plans around transparency of dividend and performance-related executive pay policies; and,
- clarificiations on how we expect companies to demonstrate financial resilience in business plans.

The consultation closed in May. We have carefully considered all responses, and we have had a large number of meetings with companies and investors to hear their views directly. We are grateful to those that have engaged with us.

Our Board met on 28 June to consider the issues emerging from the responses and to decide on next steps. To maximise the time for companies to take account of our decisions before companies submit business plans to us by 3 September 2018, we set out the decisions we have made on the consultation outcome. In reaching our conclusions, we have amended our proposals to take account of comments in consultation responses.

We will publish our full position statement, setting out a synopsis of responses to our consultation, our detailed response to issues raised by respondents and the detailed rationale for our decisions, including our assessment of the impacts, later in July.

Summary of consultation proposals and our final decision

Summary of consultation proposal	Decision
Companies with gearing levels materially above our notional assumption, should propose, in their business plans, **outperformance sharing mechanisms** that allow customers to share in the returns equity investors achieve from high gearing.	Adopt consultation position.
We will assess each company's approach to benefit sharing in the **IAP assessment**. Where proposed sharing mechanisms do not share adequate benefits with customers, we proposed to intervene to introduce a mechanism at draft determinations.	Retain the consultation position. Gearing outperformance mechanisms can differ from the illustrative mechanism if the alternative delivers equivalent benefits for customers in the round. Outperformance mechanisms can include a transition period where there is convincing evidence that this is in the customer interest. Clarify that the in the round benefit assessment includes both financial and wider impacts such as risks borne by customers.

Summary of consultation proposal	Decision
We proposed an **illustrative mechanism** with a 5% deadband above the notional gearing level of 60%. The mechanism would share 50% of the difference between notional nominal cost of equity to actual nominal cost of debt for the proportion of gearing that is above the deadband.	Retain the illustrative mechanism, but amend it to apply only to those companies with actual gearing at least 10% higher than notional gearing ie 70% gearing and above. In line with the consultation proposal, the benefits are calculated for the proportion of gearing that is above 65%.
We proposed companies should set out their **dividend policies** for 2020-25 in their business plans and explain how the dividend policies take account of delivery for customers over the period of the price control. We will assess each company's proposed dividend policy within our IAP. We expect companies to commit to publishing detail about how dividends have been determined and how these relate to the declared dividend policy and company performance in annual reports in 2020-25.	Adopt consultation position. Clarify expectation that all companies should explain how their dividend policies take account of how they have delivered for customers over the price control period.
Where companies propose base **dividend yields** that are higher than 5% in their business plans, they should explain, transparently for customers and wider society, why such higher dividends are in customers' interests.	Adopt consultation position. Confirm the reference to 5% base dividend yield is not a target nor a control on dividends set by Ofwat. We recognise actual dividend yields will be determined by a variety of reasons. In their business plans, companies may propose higher base dividend yields. Where they do so, we will seek clear evidence in our IAP assessment that such higher base yields are in the customer interest. Beyond the IAP, we expect companies to explain clearly for customers and wider society how the dividend policy and actual dividends paid reflect performance delivery to customers.
Factors which companies should consider for dividend policies include delivery of obligations and promises to customers, service and cost performance, employee interests, financial resilience.	Adopt consultation position.
Companies should set out, transparently for customers and wider society, in their business plans, their policies for **performance-related executive pay**. Policy regarding performance-related executive pay should be transparent and demonstrate a substantial link to exceptional delivery for customers.	Our IAP test will assess whether the policies set out for performance related executive pay demonstrate a substantial link to stretching performance delivery for customers, for example related to ODIs, totex or other regulatory mechanisms. We will assess whether policies set out in business plans are transparent, relevant and stretching and whether there is evidence that policies will be rigorously applied. In respect of incentives to executives, 'stretching' means stretching by reference to the business plan.

Summary of consultation proposal	Decision
We consulted on minor amendments to the **transparency IAP question**, to include highlighted text: "To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence, through **appropriate measures to provide a fair balance between customers and investors (which include outperformance sharing, dividend policies and any performance related element of executive pay) and** high levels of transparency and engagement, on issues that matter to customers (which extends to their ability to understand corporate and financial structures and how they relate to its long-term resilience)?	Adopt consultation position.
Companies should provide a minimum suite of downside scenarios for our assessment of **financial resilience** in the IAP. These comprised: • Totex underperformance (15% of totex) • ODI penalty (3% of RoRE) in one year • Inflation set above/below the independent forecasts for the UK economy as published by Treasury (3% above/below) • Increase in the level of bad debt (20%) • Debt refinanced as it matures, and new debt financed as required at 2% above the forward projections • Financial penalty – equivalent to 3% on one year Appointee turnover • Any relevant intercompany financing scenarios Combined scenario: • Cost underperformance (totex and retail 10% in each year of the price control) • ODI penalty of 1.5% RoRE in each year • Financial penalty equivalent to 1% of Appointee revenue in one year Companies should also model severe, reasonable and plausible scenarios for key variables relevant to their circumstances.	Adopt consultation position, with the following revisions to the totex, inflation and bad debt scenarios: • totex underperformance (10% of totex) • inflation scenario (high inflation scenario RPI 4%, CPIH 3%; low inflation scenario RPI 2%, CPIH 1% for each of the five years of the price control) • increase in the level of bad debt (5%) over current bad debt levels Clarify that all scenarios should be modelled to show the impacts. Where companies consider that any of the scenarios (including the combined scenario) are not relevant to their circumstances, companies should still model the scenarios, but should explain their view about relevance and explain the basis on which financial resilience will be maintained.