April 2018

Trust in water

Putting the sector back in balance: Consultation on proposals for PR19 business plans

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Ofwat

About this document

In the implementation letter to Chief Executive Officers of licenced water and wastewater, and water only companies in England and Wales, dated 13 April 2018, we set out a programme of work to rebuild trust and confidence in the water sector.

This document sets out our proposals to make targeted amendments to, and clarifications of, the methodology for the PR19 price setting process, which companies will need to take into account in preparing their business plans for submission by 3 September 2018. In particular, we consult on a new proposal for PR19 to require companies to share financing outperformance from high gearing. We also set out our expectations for PR19 business plans around the transparency of policies on dividends and the performance related element of executive pay, and how these relate to company performance. We provide additional clarification on how we expect companies to demonstrate financial resilience in their PR19 business plans.

We consider the proposals set out in this document will help put the sector back in balance with the aim of rebuilding trust and confidence in the water sector.

We welcome responses to this consultation, which consider in particular how trust and confidence can be rebuilt in this sector by putting customers at the heart of company and investor considerations, by close of business on 17 May 2018.

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1. Introduction

Our PR19 final methodology is set within the context of our strategy, 'Trust in water', which describes a shared vision for the water sector in England and Wales – one where customers and wider society have trust and confidence in water and wastewater services. Our strategy set out that to achieve trust and confidence, the sector must understand their customers and deliver outcomes which benefit customers today and in the future.

Ofwat's goal is a thriving water sector that holds the trust and confidence of customers and wider society. Trust and confidence in the water sector has been eroded through concerns around corporate behaviour of some companies and Ofwat has set out a programme of work[1] to enable and challenge companies to rebuild that trust and confidence. This consultation concerns the elements of that work which relate specifically to PR19 and so impact on the development of company business plans for the next regulatory period.

The aims of our work to rebuild trust and confidence in the water sector complement and are consistent with the PR19 themes of delivering more of what matters to customers, by great customer service, resilience in the round, affordability and innovation. We have confirmed that while we are seeking to clarify and make targeted amendments to the PR19 approach, our commitment to these overriding themes and all other aspects of the PR19 methodology we published in December last year, remain in place.

Since privatisation, investment delivered by the water and sewerage companies has been financed by debt and equity investors. These investors expect to earn a return that is commensurate with the risk associated with their investment – that being an investment in a monopoly business providing an essential service.

Our regulatory approach aims for the efficient allocation of risk between companies and customers. We allocate risk to companies and their investors where they are best able to manage it. The efficient allocation of risk helps align the interests of company management and investors with the interests of their customers. This helps to drive lower bills and better service for current and future customers. The balance of risk and return for the 2020-25 period was set out in our PR19 methodology. It

[1] We set this out in an implementation letter sent to the Chief Executive Officers of the licensed water and wastewater, and water only companies in England and Wales on 13 April 2018.

aims to link revenues more closely to service delivery and cost performance, rebalancing the focus away from financing costs. It allows investors in companies that deliver the highest levels of service, at the most efficient cost, to achieve higher returns, but also protects customers of companies that are less efficient or that provide lower levels of service. This encourages companies and their investors to focus more on what matters to customers.

The legitimacy of the regime has been challenged by companies that have paid high dividends, particularly on the basis of returns from high levels of gearing, without demonstrating any corresponding benefits to customers.

In considering how companies operate in the best interest of customers, we have revisited the balance of risk and return, particularly where it relates to the scope for financing outperformance arising from high levels of gearing. We have also revisited how we will assess the transparency of dividend policies, and the performance related element of executive pay, particularly how these relate to the service that is delivered to customers in our initial assessment of business plans (IAP).

Sharing financing gains

We have already encouraged companies to develop benefit sharing arrangements around the cost of debt where it is in the interests of customers to do so. We now propose to amend the PR19 methodology so that companies are required to implement sharing mechanisms where financing outperformance relates to high levels of gearing. We still consider it is appropriate for companies to choose their financing structures, but we consider it is important that where companies adopt higher levels of gearing, that they share their higher returns with their customers. In the absence of sharing mechanism, investors in such companies earn higher returns, with no equivalent benefit to customers.

We illustrate how the financing outperformance achieved by highly geared companies could be shared with customers. We propose that highly geared companies either adopt this mechanism in their business plans or propose alternative sharing arrangements which deliver equivalent or greater benefits to customers. As our proposals are specific to those companies with gearing above the notional level, we do not consider this should lead to any increase to the cost of equity that is set on the basis of a notional financial structure. We propose to intervene to impose a sharing mechanism for PR19 where we consider company proposals in their business plans do not adequately share financing gains with their customers.

Dividend policy and executive pay

We have revisited the dividend policies and performance related element of executive pay, as we consider it important that companies explain how these take account of the needs of customers and are formulated to ensure that the needs of customers are met. This is because dividends and the performance related element of executive pay should depend on companies having first delivered for customers. We expect companies to be open and transparent about these issues in their business plans, and we clarify how we will assess these elements in the IAP.

We propose to assess each company's approach to benefit sharing, dividend policy and the performance related element of executive pay within our IAP test on securing confidence and assurance, question 3. We propose to revise the IAP question to add specific reference to these issues with the aim to ensuring there the risks and returns are fairly balanced between customers and investors.

Financial resilience

We are also taking this opportunity to clarify and provide more detail on our expectations about the application of our methodology for the financial resilience assessment in the IAP. We highlight the importance we place on robust financial resilience assessments in company business plans, which should cover the five year period 2020-25 and beyond. It is for the Board of each company to identify, assess and manage the principal risks relevant to that company, however, to facilitate our IAP assessment we consult on the clarifications to our approach which includes a minimum suite of scenarios we expect companies to consider in assessing their ability to cope with and recover from disruption.

Application of our proposals

We consider the regulatory burden on companies of the proposals in this consultation to be minimal and are necessary for companies to rebuild trust and confidence in the regime. Our proposals associated with benefit sharing apply only to highly geared companies. We already expect companies to be transparent about their dividend policies and the performance related element of executive pay. And we already expect companies to provide an assessment of financial resilience in their business plans.

We consider the proposals set out in this consultation are relevant to companies in England and Wales and are consistent with the strategic priorities and objectives of

the English and Welsh Governments, in particular the priorities relating to resilience and a strong focus on customer protection.

The rest of this document is set out as follows.

- Section 2 sets out the balance of risk and return within the PR19 methodology.
- Section 3 discusses the sharing of financing outperformance in the PR19 methodology and sets out our requirements for companies to implement benefit sharing mechanisms in their business plans for outperformance related to high levels of gearing. This section also confirms our expectation to encourage companies to develop benefit sharing arrangements around the cost of debt when it is in the best interest of customers.
- Section 4 sets out our expectations for transparency in company business plans about their dividend policy for 2020-25 and the performance related element of executive pay and how these take account of service delivery to customers. We propose to assess this in the IAP, with particular reference to the linkages with company performance.
- Section 5 sets out the IAP test that will be used to assess company business plan proposals for assessing benefit sharing, dividend policies and the performance related element of executive pay in the IAP.
- Section 6 sets out our expectations for the statement of financial resilience in business plans and the evidence provided to support the statement.

2. The balance of risk and return in our methodology for PR19

Our PR19 methodology aligns the interests of companies and their investors with their customers by setting the balance of risk and return to incentivise companies to improve cost efficiency and service.

The key elements of our methodology which allocate risk and share benefits between investors, companies and customers are the following.

- Cost performance – companies share cost (total expenditure) out/underperformance with customers.
- Service performance – companies bear risk of service delivery for their customers, they incur penalties if they do not deliver for customers and earn returns if they deliver improvements for customers via the Outcome Delivery Incentives, Customer Measure of Experience and Developer Measure of Experience.
- Financing – our proposals allocate the risk of financing out/underperformance to companies with the exception of the cost of new debt, where our approach is to index the cost of new debt. This means companies no longer bear the risk of market movements relative to forecast at time of setting final determinations, and customers no longer pay a premium associated with forecast risk of the cost of new debt.

We also set out in the PR19 methodology a reconciliation mechanism to pass through changes in corporation tax and capital allowance rates.

Our methodology illustrated the scope for out/underperformance of the regulatory incentive mechanisms by reference to the return on regulatory equity (RoRE). In figure 1, we expand the analysis previously set out in our methodology to demonstrate the ways in which investors earn their returns. The analysis is presented against our early view of the nominal cost of equity for PR19.

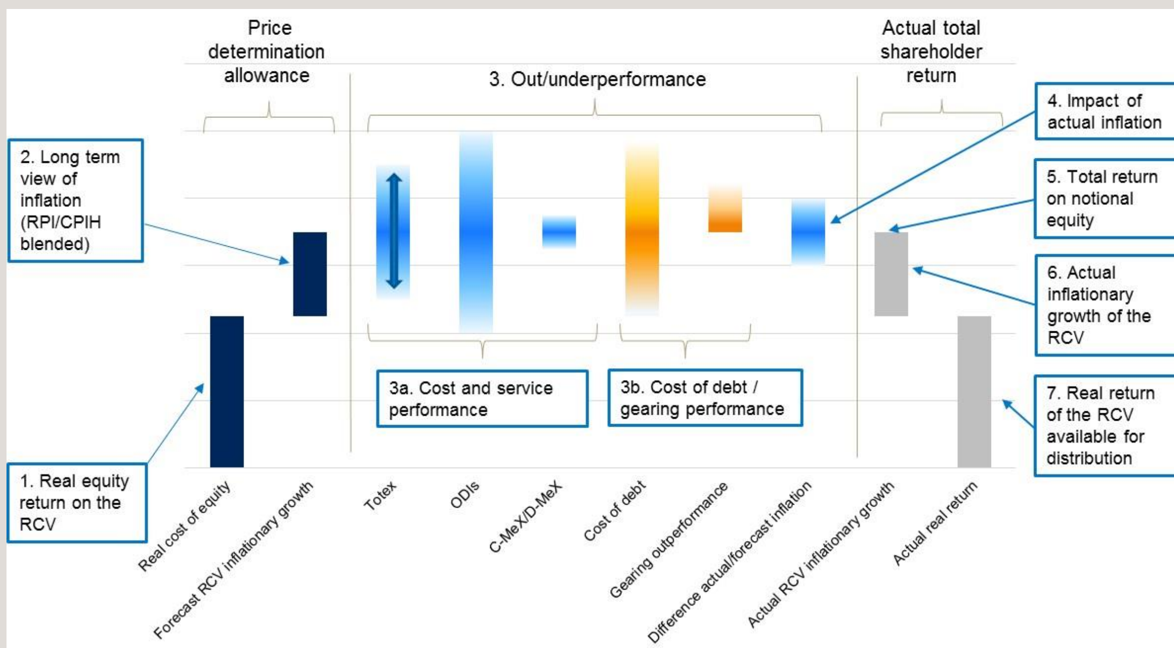
The illustration focusses on the areas where regulatory sharing mechanisms are already in place for PR19 and those areas where there is currently no outperformance sharing with customers. The sources of investor returns in figure 1 is not exhaustive. Investor returns can also be impacted by factors such as fines, gains or losses associated with pension deficit and gains or losses associated with non-regulated or other activities. The impacts arising from such factors are not suitable for sharing with customers either because they are risks that should wholly be

allocated to equity investors or fall outside of the regulated activities of the Appointee.

Illustration of the ways in which equity investors generate their returns

In figure 1, we illustrate the ways in which equity investors can generate their returns, from cost and service performance, from inflation variance, from out/underperformance against the cost of debt and as a result of choice of financial structure. For purposes of illustration we have not included out/underperformance on tax. Below the chart, we discuss where the scope for out/underperformance arises. The rest of this consultation focusses on the areas of out/underperformance that have been highlighted in the chart.

Figure 1 – Illustrative composition of the returns to equity investors



The returns on equity illustrated above are in relation to the notional capital structure. Companies with gearing (which we define as net debt:RCV) above the notional level may report higher actual equity returns (as a percentage), as returns are spread over a smaller equity base than the 40% equity base that unpins our PR19 early view for the cost of capital. Our Information Notice IN18/08 Expectations for companies reporting of financial flows for 2017-18, sets out an expectation that in the future there should be a clear comparison between the financial flows to investors on the basis of the actual capital structure and what they would have been under our notional structure in company's Annual Performance Reports.

Total expenditure – For the network plus and water resources price controls, out/ underperformance is shared between companies and customers through the cost sharing factor. The sharing factor depends on the efficiency of the costs forecast in

the business plan compared with our benchmark and on the level of out/underperformance. Reconciliation adjustments are made at the end of the regulatory period. For the retail and bioresources price controls, companies bear all of the cost out/underperformance against our benchmark. The regulatory framework incentivises delivery of cost efficiency which benefits all future customers through more efficient benchmarks.

Outcome delivery incentives (ODIs) - Companies can earn outperformance payments for stretching outcome performance; penalties for underperformance reduce bills to customers where performance falls below target levels. For PR19, ODI reconciliation adjustments will be made in-period, or at the end of the period depending on the ODI. Any improvement in performance is reflected in the benchmarks in the next period.

Customer and developer measures of experience (C-MeX and D-MeX) – Out/underperformance payments reflect the levels of experience and satisfaction of residential customers and for developers with new connections. Reconciliation adjustments will be made at PR24. The focus on comparative competition should ensure companies strive to improve service, to catch up with the best.

Cost of debt – For PR19, our methodology confirmed that we will make a distinction between the cost of new debt and embedded debt. New debt is the debt that will be raised in the price review period to refinance existing debt or to fund RCV growth within the notional capital structure. At PR19, we are indexing the cost allowance for new debt, which means that the cost allowance will be adjusted to reflect market movements in the cost of debt over the period. This reduces the risk of forecast error in setting the cost allowance for new debt and the scope for significant out/underperformance of the cost of new debt compared with previous price reviews.

Embedded debt is the debt that will not be refinanced in the price review period. Out/underperformance against the cost of embedded debt that is assumed in our cost of capital can drive out/underperformance for equity investors. We can observe the cost of embedded debt from company business plans and market information, so it is not subject to the same risk of forecast error as the cost of new debt.

In the PR19 methodology, we did not require companies to share the out/underperformance from the achieved cost of debt against the allowed cost of debt, as this will weaken company incentives to manage risk and could result in customers bearing the risk of inefficient financing decisions made by companies. However, we proposed, in our cost of debt consultation that we should leave

companies to develop their own company specific mechanisms on a voluntary basis.

Gearing outperformance – Equity investors can generate higher returns for a given level of performance by replacing equity with debt (resulting in increased gearing). Higher levels of gearing can also expose equity investors to greater downside impacts, for example where a company underperforms, or in the event of cost shocks. This may mean such companies are less able to avoid, cope with or recover from performance disruption.

Inflation - Differences between the forecast, long term view of inflation that underpins components of the cost of capital and actual in period inflation can drive out and under performance. The volatility of equity returns from fluctuations in inflation can be mitigated by companies with the use of index linked debt or derivatives, depending on company risk appetite.

3. Sharing financing outperformance

This section discusses our approach to setting the balance of risk and return associated with financing in the PR19 methodology and then considers how financing outperformance could be shared with customers.

Our approach is to allocate risk to companies and their investors, where they are best able to manage it. This encourages prudent and efficient management of risk by companies in the interests of customers now and in the long term.

We also have mechanisms in place to protect the interests of customers from companies taking excessive risk, these mechanisms include the following.

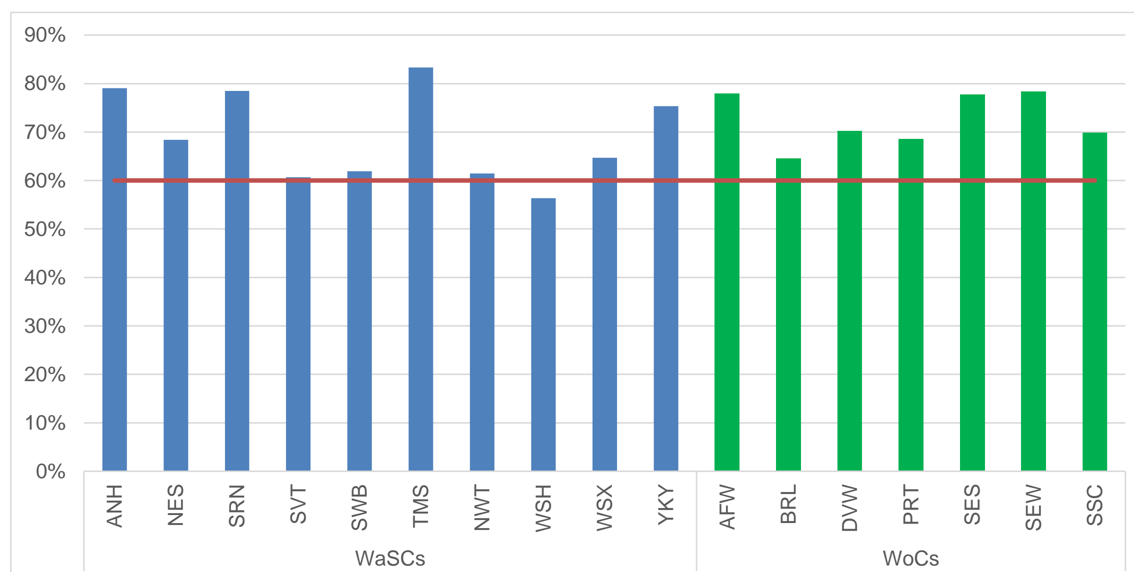
- Licence conditions[2], which require companies, among other requirements, to have in place adequate financial resources and facilities to enable them to carry out their regulated activities and to operate as an independent company. Nearly all company licences contain a requirement to maintain an investment grade credit rating.
- An assessment of company financial resilience, which, for PR19, we will carry out as part of our assessment of company business plans.

Companies are responsible for maintaining their financial resilience. And within the context of this obligation, they are best placed to make decisions about how to finance their activities. This includes the type and term of company borrowing and the proportion of their asset base to finance from debt and equity. This means that if companies make inefficient choices around financing structure or that interest rates change, the company and its investors bear these risks.

A consequence is that we regulate companies with a range of equity structures. Figure 2 illustrates that these range from companies with thin equity, highly-leveraged structures, with gearing in excess of 80%, to companies with more conventional gearing that is closer to our notional assumption.

[2] As set out in our implementation letter to the Chief Executive Officers of the water companies, we are considering separately the changes to company licences that may be necessary to rebuild trust and confidence in the sector, including a proposal to embed the board leadership, transparency and governance principles into the licence, a review of the ring-fencing conditions and to consider principles-based licence conditions. A summary of the existing ring-fence licence provisions is set out on page 39 of financeability and financing the asset base.

Figure 2 – Gearing levels reported by companies as at 31 March 2017 and the notional gearing level set out in our PR19 early view of the cost of capital



To ensure companies bear risk around financing, at PR19 (as for previous price reviews) our price determinations will be set on the basis of a notional capital structure rather than each company's actual financing structure. This means allowed returns are calculated on the basis of the same level of debt and equity for all companies.

Our approach incentivises companies to finance themselves efficiently and to minimise their debt costs. Where debt is efficiently raised, we are able to take this into account in our assessment of the allowed cost of embedded debt in subsequent price reviews, which allows customers to benefit from financing efficiencies delivered by companies.

There are two key areas where companies can out/underperform as a result of their financing decisions in PR19. These arise as a result of (i) high gearing relative to notional gearing and (ii) due to out/underperformance against the cost of debt.

We discuss the merits of adopting outperformance sharing mechanisms for these areas in the following sections.

We note that companies can also out/underperform the allowed cost of equity, due to differences between the inflation assumptions that underpin our determinations and actual inflation. Variations in market returns that underpin our cost of equity and short term actual equity market returns can also be a driver of out/underperformance. We do not propose to introduce sharing mechanisms for

these issues. Our longstanding policy is to set price controls in real terms, so that customers do not bear any risk premium associated with companies and investors bearing general inflation risk. We note also that required equity market returns are difficult to directly observe and therefore share with customers.

3.1 Sharing outperformance associated with high gearing

Equity investors in companies that increase their gearing above the notional level benefit from relatively higher returns, as company profits are shared across a smaller equity base. We have observed however that highly geared structures are potentially less flexible and more vulnerable to cost shocks than companies whose gearing levels are closer to our notional assumption. This means that companies with high levels of gearing have potentially lower levels of financial resilience, as the impact of cost shocks or poor performance is magnified to a smaller equity base. As it is companies and investors rather than customers that make the choices about financial structure, despite the safeguards that we put in place, it is possible that service to customers is put at risk in the event of failures that relate to a company's choice of capital structure.

Our work to rebuild trust and confidence in the water sector has led us to revisit our policies associated with highly geared companies. We consider our policy approach to calculating the tax[3] allowance for highly geared companies remains appropriate for PR19 as it protects customers from paying too much for the tax allowance. We continue to closely monitor company financing arrangements and are considering elsewhere how to best protect customers by licence requirements.

However, to rebuild trust and confidence, we consider there is a strong case for customers to share benefits from gearing levels that are high relative to the notional structure. In effect, customers are currently paying for an allowed cost of capital under a notional structure, but investors can benefit from gearing levels that are higher than this notional structure without sharing any of the benefits with customers. The benefits of such arrangements are asymmetrically skewed in the favour of

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[3] Our policy approach to tax for PR19 removes the incentive for companies to increase gearing to benefit from tax allowances. We do this by (i) calculating tax allowances based on the actual financial structure where gearing levels are above our notional assumption, and (ii) clawing back for customers, any subsequent tax benefit arising from a financial restructuring after price limits are set. The policy approach ensures that customers receive the tax benefit that arises from high levels of gearing.

investors at the expense of customers. This is because investors in such companies take the benefit of the difference between the cost of equity and the cost of debt for the actual proportion of gearing that is above our notional assumption[4], with no equivalent benefit to customers. Consistent with our approach to benefit sharing on costs and service, we consider it is reasonable for customers to benefit from financing performance associated with high levels of gearing.

By enabling customers to benefit from financing outperformance due to higher gearing, we enhance the legitimacy of these arrangements. Under such arrangements, companies retain the flexibility to choose financing structures and where higher gearing is prudent and beneficial, both customers and investors will benefit from these arrangements.

For avoidance of doubt, we are not proposing that customers bear any downside or costs associated with higher gearing arrangements. Such costs may arise, for example, as a result of financial distress that relates to the actual financial structure where gearing is in excess of the notional level, or costs associated with amending terms set out in covenants of highly geared companies – this is because decisions around actual financial structure are a matter for companies and shareholders who make their own choices about their financing structure.

It could be argued that equity holders will not be fully remunerated from risk of gearing up as they have to share some benefits with customers, and it is possible these arrangements could incentivise companies to reduce their levels of gearing. However, we note that companies remain able to choose their financing structure and so are not required to gear above notional levels. We also note that our longstanding policy is that we set returns on the basis of a notional financing structure and investors bear risks departing from that structure. Secondly, finance theory implies that equity returns increase in linear fashion with gearing but, typically, such theories do not reflect the benefits of securitisation arrangements. The covenants in such arrangements allow companies to achieve a lower cost of debt (and a lower cost of equity) than would otherwise be the case for a given level of gearing.

We propose that as part of PR19, companies with gearing levels that are materially above our notional assumption, should put forward outperformance sharing

[4] We note that where companies underperform against our regulatory incentive mechanisms, the impact on equity returns is greater for a highly geared company compared with the notional structure. However, where there is an equal chance of out and underperformance against the regulatory metrics, the sharing of out/underperformance with customers is symmetric.

mechanisms that allow customers to share in the returns equity investors achieve arising from highly geared structures.

We propose to assess each company's approach to benefit sharing within our IAP. Where we assess that the sharing mechanisms proposed do not share adequate benefits with customers, we propose to intervene to impose an outperformance mechanism. We will announce, and consult on, any intervention when we publish our draft determination.

We now consider how such a sharing mechanism could be designed.

3.1.1 Design of outperformance sharing mechanism for high gearing

We now discuss the design of an outperformance sharing mechanism for companies whose debt levels are above the notional level of gearing. The proposed sharing mechanism means that customers and investors share the financial gain from substituting cheaper debt for equity. It is calculated by the difference between the allowed cost of equity and the cost of debt – for the gearing above the notional level. We are open to companies proposing alternative arrangements, provided companies can demonstrate these arrangements deliver the same or greater benefits to customers.

Design of outperformance sharing mechanism for highly geared companies

Financing outperformance adjustment = gearing difference x financing outperformance difference x sharing rate

Where:

Gearing difference = Actual gearing – Notional gearing

Financing outperformance difference = Notional cost of equity – Cost of debt

Sharing rate = 50%

The proposed mechanism requires the definition of the following parameters.

- **Gearing difference** – we propose to use the actual level of gearing less the notional level of gearing. However, in practice, notional gearing varies over the price review period depending on the investment programme, and actual gearing can be impacted by factors, such as, variation in inflation, impact of actual pension deficits and changes in accounting policy. For these reasons, it may be appropriate to apply a deadband, of, say 5%, above the notional gearing level. This would ensure that operational variations in gearing do not trigger the sharing mechanism. However, it also reduces sharing of benefits with customers.
- **Financing outperformance difference** – we propose to calculate the financing outperformance difference as the PR19 allowed cost of equity less the cost of debt. The cost of debt could be defined on either a real or a nominal basis, or use a company's actual or the notional allowed cost of debt

- **Real or nominal** – Our price determinations are based on a real cost of capital ie excluding inflation. Revenues and the RCV are indexed to inflation. However, as we are transitioning the indexation of the RCV from RPI to CPIH, we will state a single nominal cost of capital and real cost of capitals in real RPI and CPIH terms. The financing outperformance difference could be calculated on a real basis, ie real allowed cost of equity less real cost of debt, or a nominal basis. If calculated on a nominal basis, the nominal cost of equity could be the nominal cost of equity that is stated in our price determination, calculated on the basis of long term inflation or it could take account of annual outturn inflation each year used to index the price control. If calculated on a real basis, the cost of equity for the purposes of the mechanism would need to be calculated taking account of the proportion of the RCV that is RPI and CPIH linked. We consider calculations on a nominal basis, with the cost of equity based on the long term view of inflation that underpins our nominal cost of capital, would be the simplest and most straightforward approach to implement.
- **Actual or notional cost of debt** – In calculating the financing outperformance difference, we could use the Ofwat PR19 allowed notional cost of debt or a company's actual cost of debt. The use of the actual cost of debt will better reflect the individual company circumstances and take account of any link between the cost of debt and the higher geared structure such as any increase in the cost of debt associated with higher gearing or benefits from securitisation arrangements. The use of the notional cost of debt will avoid the complexity of calculating the company specific actual cost of debt and continue to allocate risk of debt financing to the company. However, each company is already required to report its cost of debt in its Annual Performance Report, so there is no increase in complexity if the calculation is on the basis of the actual cost of debt. If we were to use each company's actual cost of debt, this could capture both the impact of the higher level of debt and any out/underperformance against the notional cost of debt. The actual cost of debt paid differs across the industry (see figure 3) with individual companies incurring debt costs which could be either higher or lower than the notional cost of debt. On balance, we favour the use of the actual cost of debt reported by companies as there is likely to be a link between gearing level and the cost of debt and it is more consistent with the principle of benefit sharing, where benefit from financing arrangements is split between investors and customers.

Where companies propose their own outperformance sharing mechanisms, these could be addressed either as an explicit adjustment to our price determinations, as

an adjustment that is calculated on an annual basis within the period of the price control, or calculated as an end of period adjustment. Where we intervene to impose an outperformance sharing mechanism, this will be calculated as an end of period adjustment unless companies agree that such adjustments should be made in period.

Where we apply a mechanism, we will set this out for consultation in our draft determinations, drawing on best practice approaches set out in company business plans and/or the proposals set out above, including comments we receive in response to this consultation.

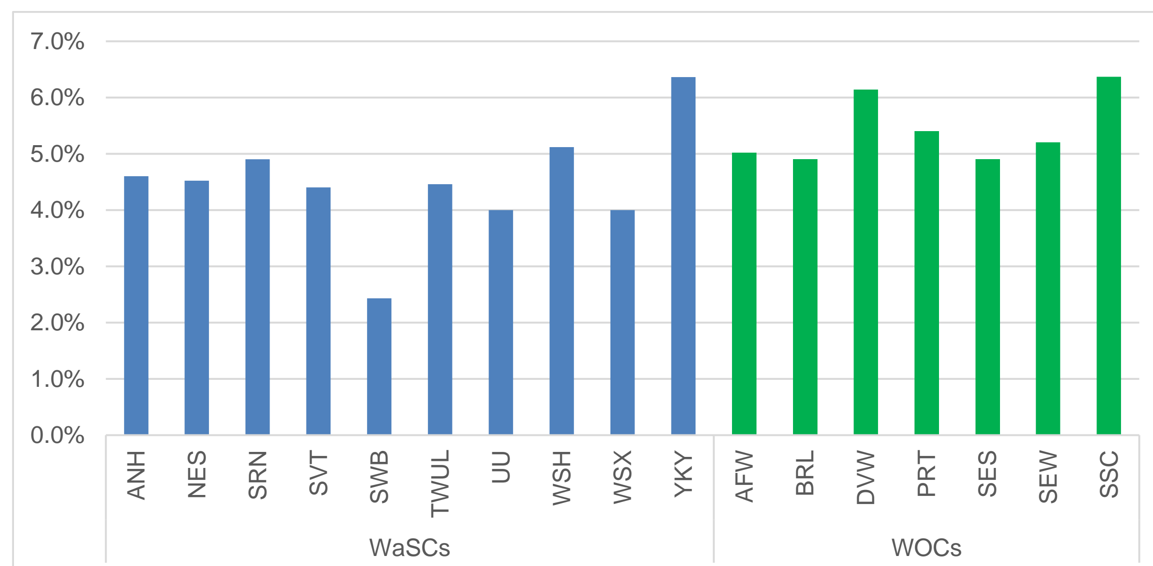
Our proposal is for highly geared companies to include mechanisms to share the benefits of outperformance with customers in their business plans for PR19 (for the financial years 2020-21 to 2024-25). However, to help restore trust and confidence in the sector before 2020, those companies who are benefiting from such outperformance now may wish to consider how they could share some of those benefits with customers in the 2015-20 period rather than wait until PR19.

3.2 Sharing outperformance of the cost of debt

When setting the cost of debt allowance for PR19, our methodology confirmed we will make a distinction between the cost of new debt and the cost of embedded debt for the notional capital structure on which our cost of capital is set. We are indexing the cost allowance for new debt, which means that the cost allowance will be reconciled to reflect market movements in the cost of debt at PR24. Embedded debt is the debt that will not be refinanced in the price review period and our methodology confirmed we would set a fixed allowance for the cost of this debt.

There is a significant variation in cost of debt performance of the companies we regulate and so scope remains for companies to out/underperform our cost of debt allowance. Figure 3 sets out the nominal cost of debt reported by companies in their 2017 Annual Performance Reports.

Figure 3 – Nominal cost of debt reported by companies in the 2017 Annual Performance Reports



In 2016, our cost of debt consultation evaluated the relative merits of introducing a mechanism for outperformance sharing of the cost of debt. We considered that:

- sharing mechanisms may weaken company incentives to manage financing risks and could expose customers to risks associated with companies' actual financing structures;
- a mandatory sharing arrangement would cut across the scope for companies to develop their own bespoke arrangements;
- sharing of underperformance could encourage excessive gearing by companies, this is because companies would be able to pass on some of the higher cost of debt from gearing up to their customers; and
- some companies developed voluntary arrangements at PR14 and we expect all companies will consider potential scope for voluntary sharing arrangements at PR19.

We proposed therefore not to introduce specific sharing mechanisms for all companies. Instead we set out that we encouraged companies to develop benefit sharing arrangements around the cost of debt when it is in the best interest of customers. This should be considered as part of any outperformance sharing with customers that companies may develop for their business plans, which we would assess as part of the IAP.

In general, where respondents commented on this issue in response to our cost of debt consultation, they considered that companies were best placed to determine appropriate sharing mechanisms.

We note that some companies such as South West Water adopted a sharing arrangement at PR14, including for new debt financing outperformance as part of their Watershare mechanism. While new debt financing outperformance is likely to be reduced or removed by indexation of new debt, in principle, this type of sharing arrangement could be extended to the overall cost of debt.

Given the proposed change to sharing financial outperformance from gearing up, we have re-evaluated the position we set out in the cost of debt consultation. We consider the reasons for not proposing mandatory mechanisms for the sharing of cost of debt outperformance set out in our 2016 consultation remain valid.

Where companies outperform the notional cost of debt that underpins our cost of capital, we reiterate that we expect companies to consider adopting their own outperformance sharing mechanisms.

We confirm that we encourage companies to propose voluntary sharing mechanisms where they have a low cost of embedded debt. This will be taken into account in the IAP, but we will not impose a cost of debt sharing mechanism as a consequence of our IAP assessment. This is unlike our proposal to impose a mechanism for sharing gearing outperformance where we consider a highly geared company has not proposed an adequate sharing mechanism.

Our IAP assessment will consider in particular, whether the benefit sharing proposed takes a balanced approach to the interests of customers, with the objective of delivering the trust and confidence of customers and wider society. It will also consider any interaction with benefit sharing mechanisms proposed for sharing of outperformance associated with high levels of gearing. Where there are mechanisms for both gearing and the cost of debt, there will be a need to ensure the mechanisms fit together. For example where a cost of debt mechanism applies up to the notional level of gearing, a gearing mechanism should then apply for the proportion of gearing above the notional level.

3.2.1 Form of debt outperformance sharing

Companies could share benefits by lowering bills, however, there are other forms of benefit sharing too - including investment (outside of the RCV) or contributions to social tariffs and other forms of customer assistance.

Voluntary bill reductions that are set out in company tariffs provide greatest transparency to customers about outperformance sharing. If companies are proposing to use sharing mechanisms other than to reduce bills, then we would

expect companies to provide clear evidence of customer support for their approach and provide compelling evidence that the whole of the customer base will share in the proposed benefit. We would also expect companies to provide assurance that any mechanism for benefit sharing, other than lowering bills, is genuinely delivering extra for customers, beyond what they are already required to deliver to meet statutory and licence obligations that should be provided from the regulatory cost allowance.

Consultation questions

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?

4. Company performance, dividends and the performance related element of executive pay

Transparency is important for building customers' and other stakeholders' trust and confidence that water companies are acting in the best interests of customers. The ongoing legitimacy debate surrounding, amongst other areas, company dividends and executive pay clearly demonstrates these are issues that matter to customers.

Our aim is for companies to be transparent about how they earn their returns. To rebuild trust and confidence, we expect companies to demonstrate how their dividend policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests. We expect companies to clearly demonstrate how their returns are shared between customers and shareholders, including any out/underperformance compared to the PR19 final determination.

We also expect companies to be transparent about how executives are remunerated and specifically how any performance related element of executive pay is linked to the underlying performance of the company. In particular that the performance related element of executive pay is aligned to delivering exceptional performance for customers.

Obligations are already placed on companies under company law, through their licence requirements and our Regulatory Accounting Guidelines. In this section we clarify our expectations related to (i) the disclosure of proposed dividend polices and (ii) the performance related element of executive pay that we expect to see in company business plans that will apply for the period 2020-25.

4.1 Transparent dividend policies that reflect company performance

To address issues related to trust and confidence to customers and wider society, companies must be transparent about how their dividends relate to delivery of service to customers. Companies can improve trust and confidence if they are able to demonstrate that dividends[5] have been paid only after they have confirmed that

[5] Our reference to dividends in this document relates to the payment of any dividend, including for example, special dividends.

obligations and promises to customers have been delivered and if they are able to explain, transparently for customers and wider society, how their dividend relates to service delivery to customers. This includes out/underperformance against performance commitments, cost allowances, sharing of financing outperformance and the impact on returns related to other issues.

Companies have legal and other requirements in respect of transparency of dividend payments:

- Part 23 of the Companies Act 2006 requires that companies must have sufficient distributable profits for dividends to be paid.
- Condition F requires most companies to report on the value of any dividend paid and provide a comprehensive explanation of the basis of the dividend; and to comply with the principles that:

  (i) the dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business; and

  (ii) under a system of incentive regulation dividends would be expected to reward efficiency and the management of economic risk.

- Our regulatory accounting guidelines, where RAG 3.09 – Guidelines for the format and disclosures for the annual performance report sets out the disclosures companies are required to make in relation to a statement on dividend policy for the appointed business.

We expect companies to set out their dividend policies for 2020-25 in their business plans and to clarify how their dividend policies take account of how they have delivered for customers over the period of the price control.

We will assess each company’s proposed dividend policy within our IAP. As we will assess proposed dividend policies in the IAP, we consider it helpful to provide guidance on our assessment for the IAP.

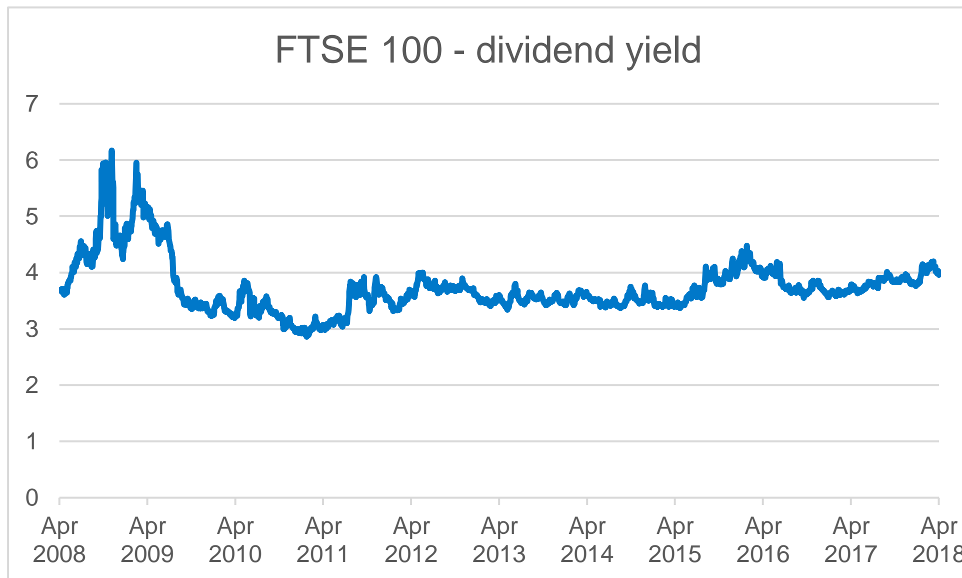
4.1.1 Assessment of dividend policies in the IAP

It is for each company to determine its own dividend policy, including the level of the base dividend, and how actual dividends reflect any adjustments for out/underperformance. Responsible dividend policies will take account of how total dividends relate to a base level of dividend based on reasonable company performance, taking account of the notional gearing structure.

The economic return to equity comprises the cost of equity that underpins our cost of capital, and the inflationary growth of the equity component of the RCV. For the notional financial structure that underpinned our early view of the cost of capital for PR19, this is 7.13% on a nominal basis. However, given that companies in this sector are typically cashflow negative, and must finance investment in the RCV, it is reasonable to assume companies should retain a proportion of the economic return.

The average payout ratio over 2011-17 for the European market as a whole was around 60%, within a range of around 40-70%. As water utilities are typically considered to be income stocks, the upper end of this payout ratio range is likely to be more appropriate to guide the maximum level reasonable for the base dividend, equivalent to a nominal base dividend yield of 5%. Figure 4 shows this to be above the historic average dividend yield for the FTSE 100. We note it is also above the real cost of equity set out in our early view of the cost of equity (which is 4.5% on a blended RPI/CPIH basis) – and so higher than the dividend policy that would be applied if we were to adopt the same methodology for financeability at PR19 as for PR14[6].

Figure 4 - FTSE 100 dividend yield for the last decade



Source: Ofwat analysis of Thomson Reuters data

[6] At PR14, the dividend policy we applied for purposes of the financeability assessment was based on a dividend yield and growth assumption, where 70% of the real cost of equity (5.65%) was used as the year 1 dividend yield. This opening dividend yield of 4% subsequently grew by inflation and 1.65% (calculated as the remaining 30% of the real cost of equity).

If companies propose base dividend yields that are higher than this in their business plans, they should explain, transparently for customers and wider society, why such higher dividends are in customers' interests.

Our IAP assessment will assess the dividend policies companies propose that affects the payment of dividends over the five years of the price control. Factors we expect companies to consider in determining their dividend policy, which we will assess in the IAP, include the following.

- Delivery to customers – the dividend policy should confirm that Boards have considered whether obligations and promises have been met before paying dividends.
- Adjustments to base dividends for performance and benefit sharing – adjustments may be positive for outperformance and negative for underperformance. Where base dividends are adjusted for performance, Boards must be clear on the sharing of financial outperformance between reductions in bills to customers and outperformance payments to their investors.
- Employee interests – the dividend policies take fair account of employee interests such as pension deficits.
- Actual capital structure – companies with high levels of gearing should consider maintaining the same dividend yield as for their assessment of dividend yield for the notional financial structure[7]. A consequence is that earnings that would otherwise be distributed will be retained, which could be used to offset borrowings and reduce gearing. Companies with high levels of gearing could adopt a higher base dividend yield, but in such circumstances companies should explain why this higher yield is in the best interest of customers.
- RCV growth – where financeability constraints arise because of an investment programme, companies may consider a base dividend that allows for more retained earnings, which can help to alleviate a financeability constraint. We note however, the dividend policy companies propose will not necessarily determine the base dividend policy we adopt for the purposes of assessing the financeability of our price determinations, as we may need to consider dividend policies flexibly in order to address financeability constraints.
- Financial resilience – we expect companies to adopt dividend policies that allow them to meet the objective of long term financial resilience. This includes the

[7] This means that if, for example, a company considered a 4.5% dividend yield was appropriate for the notional financial structure whose RCV is financed 40% by equity, the dividend yield should also be 4.5% for equity in the actual structure, if, for example, financed with only 20% equity.

wider obligations that are placed on companies, including to their employees, for example, in terms covering any pension deficit.

4.1.2 Reporting in 2020-25

In 2020-25, we will expect companies to be transparent about the dividends paid and how these relate to the proposed dividend policy in the business plan. Consistent with the requirements placed on companies to report on financial flows in the 2018 Annual Performance Reports, we will expect companies to commit to publishing detail about how dividends payments have been determined and how these relate to company performance.

We will expect companies to explain how the equity return allowed in price determinations relates to the equity return achieved under the actual financial structure and how the dividend policy relates to actual equity returns for the duration of the price control.

Transparency about financial flows and dividends

In the Information Notice IN18/08 Expectations for companies reporting of financial flows for 2017-18, we set out an expectation that in the future there should be a clear comparison between the financial flows to investors on the basis of the actual capital structure and what they would have been under our notional structure in company's Annual Performance Reports.

We expect companies will need to report such information in a similar way in 2020-25 and our forward programme of work will consider how the financial flows work will need to adapt for companies to report against the delivery of the PR19 price determinations.

4.2 Performance related executive pay

It is in the best interests of customers for the water sector to be able to attract and retain high calibre management to ensure that water companies are well run and efficient. As such, levels of pay need to be sufficient to attract management in competition with other entities with similar scale and risk. However, given the essential service nature of the businesses, it is important for customers and other

stakeholders that companies providing an essential service are transparent about how executives are remunerated and how any performance related element of that pay relates to service delivered to customers.

Pay policy is for each company's independent directors and its shareholders. Transparency on the relationship between pay policy and outperformance will help customers see how performance pay is earned in providing an essential service.

Companies already have obligations related to the reporting of executive pay.

- Section 35A of the Water Industry Act 1991 requires water companies to make a statement in relation to remuneration that is linked to standards of performance.
- We set out the requirements of the statement in section 3.2 of the RAG 3.09 – Guideline for the format and disclosures for the annual performance report.

We expect companies to set out, transparently for customers and wider society, in their business plans, their proposals for the performance related element of executive pay. Consistent with the requirements of section 3.2.4 of RAG 3.09, we expect companies to set out how the remuneration of the executive directors of the company relates to standards of performance.

We clarify that we will assess company proposals on the performance related element of executive pay in the IAP. In carrying out our IAP assessment, we will seek evidence that companies are committed to be transparent about the performance related element of executive pay and we will assess whether policies for awards of any performance related element of executive pay demonstrate a substantial link to exceptional delivery for customers, for example in terms of cost savings, and service outperformance.

Consultation questions

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related elements of executive pay demonstrate a substantial link to exceptional delivery for customers?

5. Assessing benefit sharing, dividend policies and performance related executive pay in the IAP

In sections 3 and 4 we proposed that we would assess company proposals for sharing financial outperformance, dividends and performance related pay within our IAP.

The IAP incentivises companies to produce high-quality, ambitious and innovative business plans. It will assess business plans against nine key test areas. We will use the IAP to categorise companies into four categories (significant scrutiny, slow-track, fast-track, exceptional).

The Initial Assessment of Business Plans

We set out our approach to the initial assessment of business plans (the IAP) in chapter 14 of our PR19 methodology. The IAP comprises 33 test questions under nine test areas:

- engaging customers;
- addressing affordability and vulnerability;
- delivering outcomes for customers;
- securing long-term resilience;
- targeted controls, markets and innovation;
- securing cost efficiency;
- aligning risk and return;
- accounting for past delivery; and
- securing confidence and assurance.

We set out in our PR19 methodology the test questions that will be applied in each test area. Our methodology, and the associated Appendix 13, sets out how we will look to assess these test areas, including potential features of high quality, ambition and innovation for each test question.

We consider all of the proposals set out in sections 3 and 4 of this consultation are issues that matter to customers and that impact on the trust and confidence customers and wider stakeholders place on the sector. Therefore we propose to rename the securing confidence and assurance test area to include the issue of trust ‘securing trust, confidence and assurance’. We also propose to amend test question 3 within this test area. The test question 3 was stated in our PR19 methodology as:

> "To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence through high levels of transparency and engagement with customers, on issues that matter to customers (which extends to their ability to understand the company's corporate and financial structures and how they relate to its long-term resilience)?"

We propose to amend the test question as follows:

> "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)?"

We propose that our proposals in sections 3 and 4 of this consultation, and those explained for this test in the PR19 methodology, will be assessed under this revised IAP test.

We clarify that in addition to the scope of the test that was set out in the PR19 methodology, this consultation sets out that we propose to extend the scope of this test question to:

- Assess outperformance sharing mechanisms proposed by highly geared companies that allow customers to share in the returns equity investors achieve arising from their structures.
- Take account of any voluntary cost of debt sharing mechanisms that are proposed in business plans, where it is in the customers' interest to do so.
- Assess the dividend policies companies propose that apply for the period of the price control, consistent with the issues set out in section 4.1.1 of this consultation.
- Seek evidence that companies are committed to be transparent about the performance related element of executive pay and that policies for awards of the performance related element of executive pay demonstrate a link to exceptional delivery for customers, for example in terms of cost savings and service outperformance.

Consultation questions

Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

6. Financial resilience

Resilience is one of the key themes for PR19, it encompasses all aspects of resilience including operational, corporate and financial resilience.

We define financial resilience as the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption. In this section we clarify our proposals for our assessment of company approaches to financial resilience in their business plans.

Factors that can cause disruption to a company's financial resilience will be different for each company. Some key risk factors are listed below (this list is not exhaustive and all risks may not apply to all companies).

Examples of factors that may affect a company's financial resilience

Debt/Liabilities

- Level of overall debt (gearing), cost and maturity profile of debt.
- Nature of debt (senior versus subordinated).
- Financial covenants.
- Proportion of fixed and index linked debt.
- Credit rating and potential for future downgrades.
- Contingent and other liabilities (for example pension liabilities)

Equity

- Nature of investors (active versus passive and short versus long-term) and willingness of existing equity investors to increase investment if required.
- Availability of new equity investors.

Group

- Risks arising in the wider group.
- Recoverability of intergroup loans.

Management and operations

- Quality of company management, including how they engage with Ofwat.
- Quality of risk management and risk mitigation measures.
- Revenue recovery.
- Cost variability.
- Exceptional events.

We have set out in an Information Notice IN18/04 Expectations for companies in issuing long term viability statements, our expectations of how companies should assess their financial resilience and how this should be reported in their Annual

Performance Reports. The principles set out in the information note are consistent with the consultation on a revised UK Corporate Governance Code issued by the Financial Reporting Council in December 2017[8].

[8] The Information Note sets out that if the consultation is materially different from that proposed, if required, we will issue further guidance to address any concerns.

Long term viability statements

We expect companies to include a clear and transparent statement in their annual performance report each year which confirms that the Board considers that the company is financially viable over the long term. These requirements are consistent with the UK Corporate Governance Code and build on the related Guidance on Board Effectiveness.

Approach to assessing long term viability – We expect companies to have a robust financial and operational plan that is stress tested, covers an appropriate forward looking period and that clearly states the most critical assumptions that underpin it.

Forward looking period – Companies are responsible for ensuring that they choose an appropriate period over which they make their assessment, and we expect them to provide an appropriate justification for their choice. We expect companies to look forward at least 5 years.

Stress testing – Companies should stress test their forward looking plans by modelling appropriate scenarios and sensitivities which reflect the risks that the business faces. Companies should determine the appropriate level of stress testing that they consider necessary to determine that they are financially resilient over the longer term and to justify why they consider their approach to be appropriate. The assumptions used in the stress testing should be consistent with the wider risk assessment undertaken.

Scenarios for testing – The stress tests should cover severe, plausible and reasonable scenarios for key variables, covering the principal risks facing the business in the short and longer term. Companies' assessment of risks should take into account expected performance and reflect past ability to deliver for customers. Companies should also consider the combined impact of multiple scenarios and should clearly state how the combinations have been developed.

Key variables – The variables which companies consider for stress testing should reflect the individual circumstances of each company and may include but are not limited to the following:

- Inflation;
- Revenue;
- Totex;
- Impact of ODIs;
- Unfunded costs;
- Debt service requirements;
- Unfunded pension liabilities;

- Exceptional items e.g. regulatory fines and legal claims;

Group structure – The stress testing should also consider the impact (if any) on the financial viability of the regulated business as a result of the overall group structure, inter-group transactions and other group activities outside the regulatory ring-fence.

Further funding – Where it may be envisaged that further funding will be required, the assessment should consider dependency on the company's existing financing and/or equity buffer alongside the availability of new debt or equity.

Issues arising from the results of the stress testing – Where any issues arising impact the long term financial resilience (including but not limited to any credit rating) of the company, then management should set out the action plan to address those issues and mitigate the risks.

6.1 Expectations for financial resilience assessments in business plans

The PR19 methodology sets out our expectations for business plans to demonstrate the financial resilience of the company:

> "We expect companies to provide evidence of their financial resilience. In making this assessment, we expect companies to take into account the overall assessment of the risks that the company faces. This includes risks relating to their actual capital structure and financing arrangements as well as the impact of potential cost shocks arising from, for example, underperformance against their plans or from additional financial liabilities which are not funded by customers. In confirming that they are financially resilient, companies will need to be open and transparent about their ownership and financial structures."

We expect business plans to build on the analysis companies perform for their long term viability statement, recognising that business plans relate to a defined five year period. If companies choose to take a different approach in their Business plans then we expect companies to clearly explain the reasons for the change in approach.

For the purposes of assessing the quality of business plans and to be able to compare across companies we set out a minimum suite of scenarios to be used by all companies. We also set out our expectations in relation to how companies

propose to respond in the event of a downside event that will impact on a company's financial resilience.

6.2 Scenarios used for stress testing

A company's ability to demonstrate financial resilience depends on a combination of factors which may vary for each entity as set out above. Consistent with our wider approach to business plans, companies are responsible for determining the appropriate level of stress testing to demonstrate that they are financially resilient over the longer term and to clearly explain why they consider their approach to be appropriate.

We expect companies to model severe, reasonable and plausible scenarios for key variables to support their assessment of financial resilience building on from the company's long term viability statement. The actual scenarios modelled by companies should have regard to the principal short and longer term quantified risks relevant to the company as determined in their risk assessment, which will be tested as part of the initial assessment of business plans (see Section 6.3 below)

Unless a company can demonstrate a particular scenario is not relevant, in addition to company specific scenarios and as a minimum, we expect to see the following common scenarios modelled.

- 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 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.

We also expect companies to model appropriate combined scenarios to take account of likely combinations of the above factors.

As a minimum we propose that companies model a combined scenario comprising cost underperformance to include both totex and retail expenditure of 10% in each year of the price control along with an ODI penalty equivalent to 1.5% of RORE in each year and a financial penalty equivalent to 1% of revenue in one year.

Companies may model more challenging scenarios, if appropriate to take account of risks facing their business.

If the results of the above scenarios indicate that the company's finances will not be resilient under that scenario we expect companies to clearly set out the mitigating actions they will take to address that situation or the reasons why they consider that the scenario will not arise.

The minimum scenarios we set out are not intended to be an exhaustive list and companies may need to include stress tests which go beyond the levels included within the minimum suite. Where appropriate we expect companies to include further scenarios following on from their consideration of all the principal risks specific to that company. Companies should also consider if the scenarios proposed are severe enough in their specific circumstances (for example, could totex underperformance be higher than 15%).

In building combinations of scenarios, companies should consider how the scenario may develop over time and the dependencies between individual factors, for example, high inflation leading to higher bad debt levels. In addition, we expect companies to consider any further scenarios or combination of scenarios to address the specific risks relating to their business, its capital structure or specific borrowing covenants.

We expect companies to explain how they have taken account of the impact of other group companies in their assessment and the level of dividends that have been incorporated into the modelling.

6.3 Impact of stress testing

We expect companies to explain the impact of the stress tests on their ability to maintain financial metrics and their credit rating, and their ability to service debt. We also expect companies to explain management's action plans to address any concerns arising from the stress testing, including any plans to raise additional debt or equity, including an outline timetable to achieve that. Companies should explain how the mitigation options represent the best value for money over the long term and have support from customers.

If the evidence shows there is an immediate risk to financial resilience then we would expect the company to provide a detailed plan setting out how they are addressing that risk, and how it represents a long term solution in the best interest of customers.

6.4 Assessing financial resilience in the IAP

It is the responsibility of the Board of each company to ensure they are financially resilient and to provide a statement to that effect, demonstrating how they have assured themselves that this is the case. Ofwat will assess the statement based on the evidence provided in the business plans.

Our approach to assessing financial resilience in the IAP is set out in our final methodology in four IAP test questions. For each of these questions, financial resilience is just one component of the assessment criteria. Our expectations in relation to financial resilience for three of these questions is set out below. The fourth question is dealt with in respect of the proposed dividend policy as explained in section 4.1.1 of this consultation.

Securing long term resilience - Test 1 - How well has the company used the best available evidence to objectively assess and prioritise the diverse range of risks and consequences of disruptions to its systems and services, and engaged effectively with customers on its assessment of these risks and consequences?

In respect of financial resilience, we expect each company to explain clearly how they have assessed financial resilience and provide sufficient supporting evidence for us to understand the modelled scenarios, including for example, linkages to the Long Term Viability Statement in the APR and internal risk assessment.

For the common scenarios, we expect companies to set out how relevant they consider these scenarios to be to their circumstances, for example, as they relate to their internal risk assessment processes and, where appropriate, set out additional, alternative scenarios.

We also expect companies to:

- Provide evidence to support their risk assessment, to fully explain any company specific scenarios considered and why the scenarios are relevant. The assessment should demonstrate the impact of those scenarios on the company's financial position, its ability to comply with existing covenants and the ability to raise additional finance when required.
- Provide assurance about assessment undertaken and to explain why the chosen level of assurance is appropriate.
- Clearly set out how they have determined their scenarios, including demonstrating that they have considered severe, plausible and reasonable criteria.

Securing long term resilience - Test 2 - How well has the company objectively assessed the full range of mitigation options and selected the solutions that represent the best value for money over the long term, and have support from customers?

When companies submit their five-year plan in September 2018, we will require them to show capital structures that are resilient for the long term, have a robust investment-grade rating, and can support their obligations to customers in all foreseeable circumstances.

We expect each company to clearly demonstrate that it has considered the range of measures available to secure the long term resilience of the company, and its chosen approach, including its financing strategy, best meets the objective of long term financial resilience. We also expect business plans to demonstrate that the company has appropriate processes and procedures in place to allow it to mitigate and manage risks to financial resilience that may arise as a result of circumstances that arise both within and outside of the financial ring fence.

Where there is evidence that the financial resilience of the company might be at risk, provide evidence of any mitigating actions that the management/shareholders are taking to address concerns, including additional investment by shareholders.

Securing confidence and assurance - Test 2 – To what extent has the company's full Board been able to demonstrate that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term?

In respect of financial resilience, we expect each company to clearly demonstrate that the full Board has actively engaged and assured itself that the governance and assurance processes the company has in place are appropriate to secure that the actions taken by the company will allow it to maintain long term financial resilience, relevant to the company's circumstances.

Consultation questions

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

7. Consultation questions

We welcome your responses to this consultation by close of business on 17 May 2018. Please email responses to Water2020@ofwat.gsi.gov.uk or post them to:

Benefits sharing consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4 UA

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Consultation questions

We welcome responses to the following questions, particularly responses which consider how trust and confidence can be rebuilt in this sector by putting customers at the heart of company and investor considerations.

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers?

Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

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.

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